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IN HONG KONG

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Securities and Futures Commission

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Preface

When I took the job as the Chairman of the Securities and Futures Commission in October 1998, I was struck by the fact that there was no single source of reference on the regulation and supervision of the securities industry in Hong Kong. In producing this book, we seek to fill this gap for market participants, investors, professionals, academia, students and media who are interested to know more about the what, why and how of securities regulation in Hong Kong.

The book is largely a collection of selected speeches by members of the Securities and Futures Commission and Chairmen of the Stock Exchange of Hong Kong and Hong Kong Futures Exchange, that mark the history of the securities markets in Hong Kong since 1989. It begins with an excerpt of Chapter 3 of Robert Fell's book *Crisis and Change* that describe first hand the evolution of the stock exchanges in Hong Kong until their unification in 1986. Then, following the stock market crash of October 1987, excerpts of the 1988 "Davison Report" provide the context of its recommendations to reform the securities industry in Hong Kong and the establishment of the Securities and Futures Commission in 1989.

The people of Hong Kong are proud of its tradition of the rule of law. As the custodian and the guardian of the rule of law in the securities and futures area, we are conscious of the importance of institutions, their history and the context in which any institution operates within the framework of markets. Transparency and protecting the property rights of individuals under clear, transparent and fair rules of the game are the primary objectives of any market, most of all in the dynamic and volatile securities and futures markets.

To prepare for the uncertain future, we need to understand the lessons of history, our traditions and our environment.

These speeches contain important perspectives of key leaders of the securities community in Hong Kong. Their views, which do not necessarily represent the views of the Commission, help the reader to understand how policy of securities regulation is formulated and implemented. The speeches highlight how key persons emerged within their time to create, innovate, regulate and operate the securities markets through fascinating times.

The objective of securities regulation is to foster liquid, efficient, transparent and fair markets, and in so doing protect the investor. Over the years, we have tried to clarify the role and mission of the Commission. There are numerous roles, including regulation, market development and protection of the investor. But in the end, what is the Commission here for? The simple answer is that we are here for the investor.

How we perform our job of securities regulation is a complex but interesting story. This book helps the reader understand our work better.

ANDREW SHENG
Chairman
Securities and Futures Commission
Hong Kong, May 2002

Contributors

Paul Bailey is now retired. Formerly Executive Director, Senior Director and various positions with the Enforcement Division of the Securities and Futures Commission of Hong Kong, 1989-2001; Senior Securities Officer, Office of the Commissioner for Securities and Commodities Trading, 1984-89; Various positions in the Hong Kong Police Force from 1965 including the Commercial Crime Bureau, 1972-84 (Senior Superintendent 1984).

Laura Cha, SBS was appointed Vice Chairman of the China Securities Regulatory Commission (CSRC) by the State Council in February 2001. She is in charge of the Public Offering Department, Listed Companies Department, and the Fund Management Department at the CSRC.

Prior to joining the CSRC, Mrs Cha was Deputy Chairman and Chief Operating Officer of the Securities and Futures Commission of Hong Kong. She joined the Commission in January 1991 as an Assistant Director, was promoted to Senior Director in 1993, appointed as Executive Director in 1994, and as Deputy Chairman on January 1, 1998. Prior to joining the Commission, Mrs Cha was in private practice in San Francisco with Pillsbury, Madison and Sutro, and subsequently in Hong Kong with Coudert Brothers, in the areas of commercial and corporate law and cross-border transactions by multi-national companies.

Mrs Cha obtained her B.A. from the University of Wisconsin-Madison and her J.D. from University of Santa Clara Law School. She was admitted to practice as an attorney in the State of California in 1983.

Dr Edgar Cheng, JP is the Chairman of the World-Wide Investment Co Ltd.

Aged 58, Dr Cheng had pursued several careers - in the fields of medicine, business and finance and public service - in the United States and Hong Kong over the past 30 years.

Having completed his university education at the University of Notre Dame and the Medical College of Wisconsin, Dr Cheng embarked on a medical career. He was clinical associate professor of medicine at the Cornell University Medical College and also served as physician and researcher at the Memorial Sloan-Kettering Cancer Centre. In the 1980s, he returned to Hong Kong to assist his family in business and eventually became the Chairman and Managing Director of The World-Wide Investment Co Ltd. Between February 1999 and December 2001, Dr Cheng took a leave and joined the Hong Kong Special Administrative Government as Head of the Central Policy Unit.

Dr Cheng had also served on the board of a number of listed and unlisted companies and financial institutions including: non-executive director and Vice-Chairman of Hang Seng Bank Ltd, Chairman of the Council of the Stock Exchange of Hong Kong, the Vice President of the International Federation of Stock Exchanges (FIBV), Chairman of the Hong Kong Securities Institute, Chairman of the Steering Committee on the Feasibility Study on the Financial Services Institute, member of the Board of Directors of the Hong Kong Futures Exchange Ltd as well as member of the Conference Board's Global Advisory Council. Currently he is a member of the Board of Directors of the Hong Kong Institute for Monetary Research.

Dr Cheng played an active role in Hong Kong-China affairs. In 1991, he was appointed by the Chinese Government as a Hong Kong Affairs Advisor. In 1996, he became a Member of the Preparatory Committee and also the Selection Committee for the Hong Kong Special Administrative Region of the National People's Congress.

Mark Dickens is currently a Member of the Hong Kong Securities and Futures Commission and Executive Director Supervision of Markets. He has been with the Securities and Futures Commission since early 1991, first as Senior Director Corporate Finance, responsible for takeovers and listing matters and policy and then as Member of the Commission and Executive Director Enforcement from 1997. Mark Dickens served as a member of the Hong Kong Takeovers and Mergers

Panel from July 1992 to January 2002. Prior to joining the Commission, he served in a number of positions in the Australian National Companies and Securities Commission from 1980, including General Counsel and Head of the Operations Division. He has wide experience in all aspects of securities and futures industry regulation in two Asia-Pacific markets and has participated in the work of the International Organization of Securities Commissions through various working parties. He holds degrees in Law and Economics from the Australian National University and is admitted as a legal practitioner in the Australian courts.

Robert Fell, CB, CBE has followed two main career paths. His civil service career with the British Board of Trade concentrated on international trade and finance giving him a wide range of experience and contact in the Pacific region.

His move to become the first Chief Executive of the London Stock Exchange led to an invitation by the Hong Kong government to become the Commissioner of Securities in November 1981 at the beginning of the run-up to the Joint Declaration. His three years there was followed by three years as Commissioner of Banking. After a brief "retirement" to England he returned to Hong Kong in 1987 as the new Chief Executive of the Stock Exchange of Hong Kong, a position he held until the New Council of Exchange was formed in October 1988.

He is currently an independent financial consultant and company director.

Charles Yeh Kwong Lee, GBS, JP is one of the founders of the solicitors' firm of Woo, Kwan, Lee & Lo, a major law firm in Hong Kong. In addition, he is a qualified accountant and a chartered secretary.

Since April 2000, Charles Lee has been the Chairman of Hong Kong Exchanges and Clearing Limited (HKEx). His present public appointments include: Member of the Executive Council of the Hong Kong Special Administrative Region Government since 1997; Chairman of the Council of the Open University of Hong Kong since 1998; Chairman of the Mandatory Provident Fund Schemes Authority since 1998.

He was also Chairman of The Stock Exchange of Hong Kong from 1991-1994.

Lee Quo-Wei, GBM, JP - Chairman of Wideland Investors Limited and Wei Lun Foundation Limited. A long-time banker, retired as Chairman of the Hang Seng Bank Limited on 31 December 1997 after 51 years service with the Bank and is now its Honorary Chairman. A non-executive Director of The Hongkong and Shanghai Banking Corporation Limited from 1978 to 1984. Consultant to the Board of The Hongkong and Shanghai Banking Corporation Limited from 1984 to 1992 and Adviser to the Board of The HSBC Holdings plc from 1991 to 1997. A director of Miramar Hotel and Investment Company Limited, New World Development Company Limited, Shaw Brothers (Hong Kong) Limited and Shanghai Industrial Holdings Limited. Chairman of the Council of The Chinese University of Hong Kong from 1982 to 1997 and now is its Life Member. Chairman of The Stock Exchange of Hong Kong from 1988 to 1991. Former member of the Executive and Legislative Councils, Banking Advisory Committee, Exchange Fund Advisory Committee, Economic Review Committee and the Governor's Business Council. Recipient of the Businessman of the Year award in the Hong Kong Business Awards 1994, sponsored by DHL and the South China Morning Post. Awarded Knight Bachelor by Her Majesty the Queen Elizabeth II in 1988 and the Grand Bauhinia Medal by the Hong Kong Special Administrative Region Government in July 1997.

Anthony Francis Neoh, SC, JP is Chief Advisor to the China Securities Regulatory Commission. In addition to being Visiting Professor at Peking University, he holds various adjunct academic appointments in universities in China, including Hong Kong. For the Academic Year 2001 - 2002, he will be visiting Professor from Practice at the Harvard Law School.

On 1 July 1997, he was appointed by the Standing Committee of the National People's Congress as a Member of the Basic Law Committee. Mr Neoh's other formal PRC Mainland appointments include: Arbitrator, China International Economic and Trade Arbitration Commission, Hon. Legal Advisor to the Shenzhen, Xiamen and Fujian governments, and Economic Adviser to the City of Tianjin.

He was Chairman of the Hong Kong Securities and Futures Commission from 1995 to 1998 and chaired the Technical Committee of the International Organization of Securities Commissions from 1996 to 1998. Prior to this appointment, he had held various directorate positions in the Hong Kong civil service (1966-1979) the last of which was as an Assistant Director in the Independent Commission Against Corruption.

He was at the private Bar from 1979 to 1995, and had been a deputy judge of the High Court in the Supreme Court of Hong Kong. He was appointed Queen's Counsel (now retitled Senior Counsel) in April 1990. He practised in San Francisco with the law firm of Pillsbury, Madison and Sutro, as a member of the California Bar.

Mr Neoh served as a member of the Hong Kong Stock Exchange Council and its Listing Committee, and chaired its Disciplinary Committee and Debt Securities Group. He was instrumental in developing the legal framework which facilitated the listing of PRC enterprises on the Stock Exchange of Hong Kong.

Robert Nottle, CBE, MAICD, M.Comm is now semi-retired, but still has close links with the Australian Stock Exchange (ASX). His main role is as a Director of ASX Supervisory Review Pty Ltd (which monitors ASX's performance as an SRO). He is also Chairman of the S&P/ASX Index Advisory Panel, a Member of The Financial Reporting Council of Australia, a Director of The Australian Accounting Standards Board, Member of The Business Regulation Advisory Group of Australia and Chairman of the Monitoring Committee to harmonise Australian Accounting Standards with International Accounting Standards. From 1995 to 2000 Robert worked with the Australian Stock Exchange, first as National Director (Supervision) and from 1997 as Deputy Managing Director with responsibility for the revenue earning business of ASX. From 1989 to 1994, Robert was Deputy Chairman and Chairman respectively of the Securities and Futures Commission. Prior to that (from 1981 to 1988) he held senior positions at the National Companies and Securities Commission in Australia.

Robert Owen - After graduating from Oxford University in 1961, Robert Owen joined the UK Foreign Office, serving five years at the British Embassy in Washington DC. From 1968-1970 he was a Private Secretary at H.M. Treasury in London.

In 1970 he joined Morgan Grenfell, the UK merchant bank, where he became a director in 1973.

In 1979 he joined Lloyds Bank International as Director of Merchant Banking, and in 1982 became Director, Asia-Pacific. In 1984 he was given the task of forming Lloyds Merchant Bank and became its Chairman and Chief Executive, as well as Director of Investment Banking for the Lloyds Bank Group.

In 1988 he was recruited by the Hong Kong Government as Adviser on Securities Markets (and became concurrently Commissioner for Securities) to lead the implementation of extensive reforms to the regulation and operation of Hong Kong's securities and futures markets. These included the establishment of a new statutory body which was later named the Securities and Futures Commission (SFC) in 1989, to assume primary responsibility for regulating Hong Kong's securities and futures markets and to supervise and encourage their development. He became the SFC's first Chairman and served three years in this position, during which time the new regulatory system was firmly established and a number of further reforms and market development measures were introduced.

Since 1992, Robert Owen has been Vice Chairman of Nomura Asia Holdings and Senior Adviser to Nomura International (Hong Kong) Ltd. He is also Chairman of Techpacific Capital Ltd and a director of Sunday Communications Ltd as well as Chairman of the International

Securities Consultancy Ltd and a director of European Capital Co Ltd in London.

Andrew Sheng, SBS, JP - Chartered Accountant. Educated at the University of Bristol, where he received a First Class Honours Degree in Economics.

Held various positions with Bank Negara Malaysia (Central Bank of Malaysia), including Chief Economist and Assistant Governor in charge of Bank and Insurance Regulation from 1976-1989. Seconded to the World Bank, Washington, DC, as Senior Manager, Financial Markets and Payments Systems, Financial Sector Development Department from 1989-1993. Appointed Deputy Chief Executive, Hong Kong Monetary Authority, responsible for the Reserves Management and External Departments from 1993-1998.

With effect from 1 October 1998, Chairman of the Hong Kong Securities and Futures Commission.

He received the LLD (Hon) University of Bristol in 1999.

Michael Wu is an Independent Director and a member of the audit committee of SW Kingsway Capital Group. He has over 10 years experience in the regulatory industry and was the Deputy Chairman, Chief Operating Officer and Executive Director of the Securities and Futures Commission of Hong Kong. Currently, Mr Wu is an advisor for the China Securities Regulatory Commission and Deputy Chairman of the Shanghai Stock Exchange.

MT Geoffrey Yeh, SBS, MBE, JP, studied in the USA where he obtained a B.Sc degree with honours from the University of Illinois in 1953 and a M.Sc. degree from Harvard University in 1954. In 1982 he received Honorary Doctorate Degree (DCS) from St John's University, New York. Professionally, a Fellow of Chartered Institute of Building, UK, Fellow of the Hong Kong Institute of Directors and Hon. Fellow of the Institute of Construction Managers.

In 1955, he returned to Hong Kong to join Hsin Chong & Co, a construction company founded in 1939 by his late father, Mr KN Godfrey Yeh. He is currently the Chairman of Hsin Chong Group of Companies, including Hsin Chong Construction Group Ltd, a public listed company in Hong Kong and Hsin Chong Land Ltd, a real estate investment and development company and other companies by the name Hsin Chong. He is currently a Non-Executive Director of Hysan Development Co Ltd and China Travel International Investment Hong Kong Ltd.

In June 1991 he was an independent director of Hong Kong Futures Exchange Ltd. In 1993 he became a Vice Chairman and from June 1998 to March 2000, as the Chairman. All positions held at the Hong Kong Futures Exchange were non-executive.

He has been the Honorary Consul of Jamaica in Hong Kong since 1985.

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The Commission gratefully acknowledges their contribution and many un-named colleagues, who made this important record of the history of securities regulation in Hong Kong possible.

PART I

Early History of Securities Markets in Hong Kong To 1988

The history of the Hong Kong securities market is well documented by Mr. Robert Fell, the first Chief Executive of the London Stock Exchange, who was appointed the Commissioner of Securities in Hong Kong in November 1981. This chapter is an excerpt of Chapter 3 - Towards the Unified Exchange - of his book entitled "Crisis and Change", Longman, 1992.

ROBERT FELL

1 Towards the Unified Exchange

"Crisis and Change", Longman 1992

Geography and history have made Hong Kong a home for the largest congregation of Chinese outside China. They live in a British colony under its own peculiar system of government and owe a transitory allegiance to the British Crown. This highly anomalous community has achieved a remarkable level of prosperity and economic development which, in turn, has generated important and perhaps unexpected secondary developments, including an important international securities market. Dealing in securities is almost as old as the colony itself. But the pre-war history of stockbroking in Hong Kong has little relevance to today's international market. The origin of the modern market is as recent as the opening by Ronald Li of the Far East Stock Exchange on 17 December 1969. The relevance of its early history is that securities issuance and dealing developed within the British system, particularly company and contractual law and financial practices. More relevant by far than its own history is the remarkable general level of prosperity achieved by 1969. This achievement created not only a more plausible need and base for a securities market but also, and simultaneously, the supply of disposable wealth to provide the liquidity necessary for trading in size.

Trading in Hong Kong in company shares can in fact be traced back to about 1860. In 1891 the Association of Stockbrokers in Hong Kong was formed, changing its name to the Hong Kong Stock Exchange in 1914. From that association, Hong Kong can trace 100 years of development for its stock exchange even though the original exchange was exclusive, representing only the British and international community. A second exchange, called the Hong Kong Sharebrokers' Association, was started in 1921, giving for the first time a wider membership from the local Chinese population. The two exchanges merged in 1947, and under the name 'Hong Kong Stock Exchange', held a monopoly until 1969. This Hong Kong Stock Exchange, with its 90 registered brokers, dealt professionally with the then existing market and the economic demands placed on the market. Its ethos was recognised and appreciated in London, and the exchange enjoyed admission as a member to the International Federation of Stock Exchanges. With a degree of care about membership and the listing of securities, the exchange fulfilled the classic functions of a stock exchange - the raising of capital for business in exchange for securities and the provision of a secondary market in which holders of existing securities can sell to those who want to invest their savings. The exchange, was, however, predominantly a local secondary market. Before 1942 Shanghai was by far the larger market in the Far East in line with the comparative size and nature of the two economies.

Immediately after the war there was a burst of activity following the flow of migrants from Shanghai. Gradually, however, the annual turnover on the exchange steadied at less than HK$200 million. As the Companies Law Revision Committee later recorded, the market was 'in the doldrums' for about 12 years. Modern activity began in about 1959 when a number of companies, mainly utilities, went public. Small investors were attracted to the market, as offers were made at a low price which quickly went to a premium. Hong Kong's early industrial growth led to the first of its post-war booms. In 1969, 32 new banks and branches were opened in Hong Kong, bringing the total to 86 licensed banks with 142 branches. The exchange reflected this financial growth with a fourfold increase in turnover and a peak in 1961 of HK$1,414 million as the market attracted some of the influx of foreign capital attracted by Hong Kong's rapid development. Taking advantage of the interest in the market which coincided with a wish of some of the original shareholders to sell their shares, Jardines offered shares to the public for the first time. In June 1961, 900,000 shares comprising 25 per cent of the issued capital were offered at HK$16 a share. The issue was oversubscribed 56 times, causing a minor bank run. At the end of the first day of dealing, the shares stood at HK$31.25, a premium of 92 per cent over the issue price, and the return of the oversubscriptions further fuelled the market boom.

A banking problem brought this bull market to an end. At times the market became static. Over periods of months in 1965 Jardines stock, for instance, moved hardly at all at quotations of HK$12/12.5 to 12/12.75. In 1967 there was the additional political aggravation with the spillover from the Cultural Revolution which caused the Hong Kong Stock Exchange to close twice for periods of ten days in order to avoid panic selling during the civil disturbances.

Even a small market has its excesses provoking calls for intervention, but the stock market at that time was not of immediate concern to the government. Only some 65 securities were listed, with active share dealing in only 25 stocks, particularly in the eight utility companies. Overall, as Mary Higgins points out in her study entitled *Securities Regulation in Hong Kong*, capital in Hong Kong did not move through the stock market: it moved through the banks. From 1955 to 1964 full employment with high wages brought increasing bank deposits, and 'the banks drew on these funds to finance trade and corporate expansion. Hong Kong operated on a smooth system of indirect financing.'

It was the rapid development of the banking sector which was of concern, with an inquiry in 1962 into the appropriate regulation for banks in Hong Kong. The inquiry led to the *Banking Ordinance* of 1964, but despite one of the findings of the inquiry being that some banks were overcommitted to the property and securities markets, no action was taken directly in securities regulation. Exchange companies were unregulated and yet in a sense enjoyed special privileges. Anyone could form a company to run a stock exchange. In addition, the

Companies Ordinance, which restricted offers in writing to the public of shares for purchase, did not apply to shares quoted on or permitted to be dealt in by a recognised stock exchange. Even the apparent restriction of a stock exchange being 'recognised' was in effect no restriction as, until 1970, there was no legal definition of such recognition.

But the market was changing. The economic recession of 1965 led to the failure of two banks. Then came a severe general bank run with the takeover of the Hang Seng Bank by the Hongkong Bank to rescue it from the consequential liquidity problem. The banking crisis was contained by the end of 1965 but, following the crisis, financial and business circles anticipated a period of tight money, particularly in light of new government requirements for minimum reserves for banks. As a result, a few listed companies attempted the path of rights issues, and their success produced something of a shift to equity financing. The number of rights issues increased and a number of family-owned companies took advantage of the liberal listing rules to put 25 percent of their companies into public ownership. In 1968 turnover had reached HK$944 million, its second highest level.

Then came the dynamic shift of the Hong Kong market. Once the overflow from the Cultural Revolution had been contained, the prosperity of the decade became apparent, with increased savings seeking a form of investment more profitable than deposits in a bank. Hong Kong was seen for the time being as no longer the priority matter for Beijing, and the political climate permitted investors to relax. Ronald Li, sensing the market potential, at first attempted a change of membership in the Hong Kong Stock Exchange. Failing in this, he opened the Far East Exchange, a Cantonese exchange and avowedly of more speculative intent than the original exchange. In 1969 a bull market was already under way, with securities turnover reaching HK$2,125 million; in 1970, the first full year of the Far East Exchange, turnover rose to about HK$6,000 million, an increase in the year of 135 per cent. The securities revolution had started.

The pickings were too good to be left to the two exchanges. At the end of 1970 seven companies formed for the purpose of running stock exchanges were incorporated under the *Companies Ordinance*. This incorporation meant that they had formed the company structure and completed the necessary procedures for registration as companies. Four of the seven were incorporated in 1970, although only two of the seven were trading in that year - the original Hong Kong Stock Exchange, with its lineage to 1891, and the Far East Exchange, which had opened its doors at the end of 1969. The next to start trading, the Kam Ngan Stock Exchange, formed basically from members of the gold market, opened its doors on 15 March 1971. With three exchanges now offering their services, total turnover in 1971 approached HK$15,000 million, a further increase of 150 per cent on the previous year. The Kowloon Stock Exchange, the fourth exchange, opened on 5 January 1972 but never became a serious contender for share of turnover. Altogether, however, the exchanges generated a turnover of HK$49,000 million in 1973 - almost 25 times the level in 1969 before the advent of the Far East Exchange. By 1973 Hong Kong found itself with 1,006 men and women who had decided to style themselves as stockbrokers!

A major lasting innovation arising from the popular interest in market activity was the introduction of the Hang Seng Index. The Hang Seng Bank, very much the people's bank, had begun to computerise and had developed the index for its own internal measure. The index was opened to the public in November 1969. The starting measure was of 33 constituent stocks as at 31 July 1964, which were given a value of 100 points at a quiet time without any particular activity influencing the market. Q.W. Lee, the innovator, did not realise the part he would later play at the exchange.

A huge speculative bubble had now been blown up by the exchanges from the new layer of savings and also from the support of banks which, having recovered their liquidity, began to lend on an unprecedented scale for stock exchange activity. The timing had been near perfect. The New York Stock Exchange, which had traditionally attracted Hong Kong investors, had become a bear market early in 1969, and overseas mutual funds had also run into trouble. New listings appeared to absorb the furious rate of subscription. In 1973 the exchanges produced 53 public offers and 48 placements. This was Hong Kong's period of excess, comparable with the beginnings of the London market at the end of the 17th century. Some sensible companies were floated, while other listings were strange and offered on curious terms. Some new issues reached levels of 500 per cent of the issue price. Queues formed for prospectuses - not to read the small print, but to obtain the subscription form. As one observer at the time put it, the value of a share had nothing to do with economic ratios; it was merely the price it could be traded at in the next day's session. By early 1973 the Hang Seng Index had reached a record high of 1,775 points.

Probably the most important listing in this period was of the Hang Seng Bank itself on the Hong Kong Stock Exchange, the first bank since the war to seek a listing. Depositors queued at other banks to withdraw their money and apply for the one million $100 shares on offer. When the lists closed on 6 June 1972 the offer was oversubscribed 29 times with an amount in excess of HK$2,800 million, equal to nearly half the government's revenue in 1971. When the shares were traded on 13 June 1972 the price went to a high of HK$186. As the South China Morning Post reported, 'Great wads of folding money for lucky investors and a stampede on the Hong Kong Stock Market marked yesterday's triumphant debut for the Hang Seng Bank.' No doubt there were also quiet celebrations in the boardroom at No. 1 Queen's Road, the Hongkong Bank having taken 51 per cent of the equity of Hang Seng in 1965.

At the outset the attitude of the government was one of benevolent neutrality. The immediate benefit for government was the sudden increase in revenue from stamp duty. The general climate was still one of non-intervention. The government had, however, not been absolutely caught out. In 1962, at the same time as the government reviewed its banking legislation, it had set up the Companies Law

Revision Committee. Company law at that time was based on the United Kingdom legislation of 1929. The idea in 1962 was that a group in Hong Kong would receive the seminal report of the British Jenkins Committee and revise Hong Kong's legislation in light of Jenkins. Unfortunately, the Hong Kong committee put off its work in the expectation of swift action in London with new company legislation. The London action fell foul of political changes and, in the meantime, the Hong Kong government had to divert its scarce resources to dealing with the banking problems of the mid-1960s.

The Companies Law Revision Committee was reconstituted in 1969 and set to work with public consultation in 1970. The committee thus had the benefit of sitting while the securities revolution developed and the new exchanges were writing their large new business. The chairman was W.K. Thomson, representing the Attorney General, and members included C.H. Wong representing the lawyers, who later was chairman of the Securities Commission at the time of the 1987 market collapse, Gordon McWhinnie representing the accountants, who was a prominent member of the commission when I arrived in Hong Kong and, representing company secretaries, Peter Scales. Their first report, on investor protection, was presented in June 1971 and its 252 pages are a model of clarity giving a historical insight into informed Hong Kong thought at that time.

The committee examined the investment opportunities offered to the Hong Kong public and the forms of protection afforded similar investors in the major overseas centres. Basically, the committee was against statutory intervention but was attracted to the fashionable wave in London, Singapore, and New South Wales of protection by registration of dealers and documents. Recommendations were framed in the Hong Kong context. As there was no equivalent in Hong Kong of the British Board of Trade, the committee deliberated as to whether the registration protection should be administered by the Registrar General with his general company law responsibilities. By that time a new government post, The Commissioner of Banking, had been created to supervise the regulation of banks. Taking this post as their model, the committee recommended the appointment of a Commissioner for Securities to assume the registration and monitoring process. Other duties could be added, such as the monitoring of unit trusts and mutual funds, and the general promotion of investment opportunities.

As with the banking regulation, there would be no commission. Instead, there would be an advisory committee composed of men knowledgeable in the securities industry, with the commissioner as an *ex officio* member and providing the secretariat. The committee noted the growth of business in the new stock exchanges but did not see any need for government intervention. Their considered view was:

> We are fully convinced that Government should not get deeply involved in attempts to regulate and supervise stock exchanges and should confine its activities in the main to ensuring that stock exchanges take action through regulation to remedy abuses whenever they occur or show signs of developing.

Nor were they concerned at the multiplicity of exchanges. The number, they concluded, would eventually be settled by economics: exchanges would succeed or fail according to whether they achieved a viable market share of business.

The committee considered, however, that statutory regulation should be applied to company takeovers. Their novel reasoning was that as the London 'City' infrastructure did not exist in Hong Kong, the City type of a code of practice for takeovers could not be effective in the Hong Kong market. The government reacted quickly to the report, no doubt stirred by the excesses now apparent. The first step was to create a Securities Advisory Council, more to give 'authoritative guidance' to the exchanges in the spirit of the dictum of the Companies Law Revision Committee than to apply detailed regulation. In January 1973 the first Commissioner for Securities was appointed.

Towards the end of 1973 came the Yom Kippur war and the massive increase in the price of oil. World inflation and general economic conditions meant the end of the bull market. The immediate prick in the Hong Kong bubble was the discovery of forged share certificates. By 1974, with the general tightening of credit conditions, the bubble was well and truly burst, with annual turnover falling to HK$11 billion, less than a quarter of the 1973 peak. By December 1973 the Hang Seng Index had dropped to 400 from the record high at the beginning of the year, and by December 1974 it reached a record low of 150 points. Although there were few broking failures, many people had lost money and left the market. Following the classic pattern of government being forced to act after the event, the new system of regulation was given statutory form after the collapse of the market, and from 1 March 1974 the *Securities Ordinance* and the *Protection of Investors Ordinance* became effective. A government machine was now involved in the securities market. Dealers had to be registered, and 1,200 applications were received.

In the *Hong Kong Annual Report, 1981*, Robin Hutcheon described the bubble as:

> a brief era of madness that neither the government nor the people will soon forget. ... Certainly many fortunes were made. Just as certainly many were lost. And while many big companies and knowing individuals creamed large profits from this speculative aberration, the small investor was to learn a lesson that would last for many years. ... It was an era of much more than bruised pride and burnt fingers. Many, including some who had lost everything in the Sino-Japanese war, made it up in the post-war years, lost it again in the Chinese civil war, made it up again in 25 years of prosperity in Hong Kong, lost it all in 1973. And the share market was to remain in the doldrums for five years.

It was not only the stock market which was in trouble: Hong Kong began to experience its only deep recession in the post-war period. In 1972 China began to charge international prices for the basic goods it supplied to the colony. The fourfold increase in oil prices also hit the world economy. The sharp drop in trade and industrial production caused widespread unemployment and cuts in earnings. Between March 1973 and March 1975, real wages fell by more than 18 per cent.

There was fortunately another side to the gloomy coin. Out of the securities excess, Hong Kong was left with a more experienced market, a change in membership of the exchanges with the injection of overseas interests and, through the genius of Fung King-hai, the establishment of Hong Kong's largest broker. In addition, the securities activity produced an opening for merchant banks. In 1971 Schroders began business in partnership with the Chartered Bank and the Kadoories. Robert Fleming followed to combine with Jardines to form Jardine Fleming, and the Hongkong Bank formed its own subsidiary, Wardley Limited. The 'City' infrastructure found absent by the Companies Law Revision Committee was beginning to form. On the wider front, there was an impetus to devise new products and Hong Kong moved successfully into plastics, electronics, and watches. A hungry industry searched for new markets. In 1976 per capita GDP surged with a growth of 25 per cent. Hong Kong was on the march again. Wages in 1978 recovered their 1973 levels and continued to move sharply upwards.

Against this background the first Commissioner for Securities began his stint. The immediate jobs for James Selwyn, a former economist of the Bank of England, were the creation of the office under his new powers and putting into some sort of shape the hitherto unregulated market. The Report of the Companies Law Revision committee gave him a useful reference guide, as it detailed the regulatory practices in other markets. The report had also drawn attention to the New South Wales legislation, which was used by the Hong Kong law draftsman as his guide. The severity of the crash, however, jolted confidence in the ability of the exchanges to reform themselves without intervention, and decisions were taken contrary to the recommendations in the report. The *Stock Exchange Control Ordinance* was enacted to prevent any additional exchanges being opened, and the advisory committee gave way to a full commission.

The commission members were the 'great and the good' from the business community but there was little cohesion at the outset.

Nevertheless, the commission did work remarkably quickly given the unpromising background. By August 1975, again contrary to the report but because an infrastructure was now in place, a code modelled on the London practice was issued to guide takeovers and mergers. The main strategic thrust, however, was the drive to replace the four exchanges by a single, unified exchange. Given that the exchanges were four separate companies each competing for market share and its own profitability, the steady and successful progress over six years was, in retrospect, a solid achievement.

In July 1974 the four exchanges came together to form the Hong Kong Federation of Stock Exchanges. Each chairman took turns in the office as chairman of the federation. While the resolutions of the federation had no legal force, the body became something more than a talking shop. By May 1977 a working party was set up of the exchanges specifically to work with the commissioner to establish a unified exchange. In July 1980 The Stock Exchange of Hong Kong Limited was formed as the incorporated basis for the projected exchange, and in the following month the Legislative Council enacted the necessary legislation for the unification process.

With securities trading comparatively quiet in the years following the collapse of 1973 and 1974, attention focused sharply on membership of the exchanges, particularly in an effort to protect existing restrictive practices in a dull market and, consequentially, the right of entry to and the market share in the projected unified exchange. In 1969 a London broker had been admitted to the Hong Kong Stock Exchange on the basis that his business would be executed by a local member who would receive full brokerage. Hoping to become full members in due course, other London brokers took up similar associate membership, although they paid full membership terms on admission. The *Securities Ordinance*, however, permitted under the law the admission of corporate members regardless of exchange practice. On its enactment, the London brokers applied for full membership.

Such a move would have changed at an early date the basis of membership of the four exchanges, but a poll of local brokers showed an overwhelming objection to the full admission of overseas members. The Hong Kong Federation of Stock Exchanges therefore resolved in February 1975 that overseas members of exchanges should be advised that they would not be accepted as full members. A reasonable conclusion was that membership of the unified exchange would be based on the traditional Hong Kong basis of local sole traders with overseas membership on associate terms. Another possible membership change, a move by the then chairmen of the Hong Kong Stock Exchange and the Far East Exchange to amalgamate, failed because of opposition from the members of the older institution.

In 1979, however, Ronald Li produced the next innovation, with the Far East Exchange breaking ranks and admitting Evans Lowe of Richardson Securities of Canada as a full member. The Hong Kong Stock Exchange, as guardians of the principle of only local full membership, complained to the Financial Secretary and to the Securities Commission. The commission, however, had no statutory standing: the federation resolutions were not legally binding and, in any case, the *Securities Ordinance* had permitted corporate membership without any nationality barrier. The federation then attempted to resolve the difficulty by enforcing a membership cordon around the single breach of its rules. In July 1979 it resolved that:

> ... any approach by an overseas member, or a person reasonably suspected to be acting on behalf of an overseas member, to any member Exchange seeking full membership would immediately be brought to the attention of the Council [of the federation].

To underline the purpose of the resolution, the federation minutes recorded:

> The intention of the resolution is to deny overseas members, or overseas member firms, or persons reasonably suspected to be acting on behalf of an overseas member or overseas member firm, full membership of any stock exchange in Hong Kong.

The Securities Commission took this clear and firm resolution as their guide in drafting the unification legislation. Taking note of their strong opposition to overseas members, the commission formed the view that the local brokers needed some protection from overseas competitors and recommended membership of the new exchange to be on the long-accepted basis of local sole traders with only associate membership for overseas interests. The view was accepted by government and became the basis of the Unification Ordinance enacted in August 1980.

But in October 1980 - that is, after the policy for the new exchange had been formulated, accepted, and enshrined in legislation - the Far East Exchange again broke ranks and admitted as a full member the local director of the London firm of Vickers, da Costa who, up until that time, had been an associate member of the Hong Kong Stock Exchange. A miniature membership war had broken out. There was no new appeal to the federation. Instead, the Hong Kong and Kam Ngan exchanges retaliated by offering full membership to their overseas members. Ten overseas members accepted and became full members with the intention, supported by their exchanges, of gaining the same status in the unified exchange. The fact that the unification legislation made such membership impossible was disregarded.

The gulf between what was legally permitted under the *Unification Ordinance* and what had actually developed in the membership of the exchanges was wider than either the commission or the exchanges had realised. Under the legislation, no corporations or partnerships could be members of the unified exchange. In reality, the exchanges had a variety of corporate and partnership members. A seat might be in the name of a single person but be bound to the beneficial owner by a deed of trust or by some covert agreement. The beneficial owner might be a partnership or company domiciled in Hong Kong or overseas. Any deeds of trust were subject under the legislation to the agreement of the committee of the unified exchange, which had complete discretion regarding their approval. Legally, a deed of trust with a non-member was likely to be declared invalid, as the basis of the legislation was to guarantee a closed membership of local sole traders. The barrier was not against the foreigner; for instance, it would have operated equally against the largest local broker who was the beneficial owner of a seat on each exchange controlled by deeds of trust. While some brokers, mainly the London brokers, were uneasy about the divergence between legislation and reality, the outsiders took comfort from an opinion that their deeds of trust would be approved because their seat on an existing exchange appeared to guarantee the offer of a seat on the unified exchange. This 'natural justice' comfort evaporated at the first test.

Until the first committee of the unified exchange had been elected, the legislation provided for its management to be rested in a transitional committee consisting of members of the Federation of Stock Exchanges. The Transitional Committee, with Woo Hon-fai in the chair, had the duty to receive applications for membership of the new exchange and to grant membership if they approved. Woo Hon-fai and the members of his exchange took their philosophy from their base, the Chinese Gold and Silver Society. Their attitude was partly chauvinistic but mainly coloured by the benefits they calculated flowed from a tightly controlled and Chinese membership.

On 30 September 1981 the Transitional Committee in screening applications for membership, acting within their discretion and their interpretation of the law, followed their natural instincts and decided to reject all applications involving a deed of trust with a non-member. In other words, a reversion of policy was intended to return to the position before the admission of Evans Lowe and Vickers, da Costa into the Far East Exchange. In line with this reversion of policy, the committee intended to reject about 50 applications, including the representatives of the local Sun Hung Kai as well as the overseas brokers. The commission at this stage was in some disarray with the absence of the commissioner. Fortunately, Derek Murphy, then a senior staff member, appreciated the crisis which such a decision would have created and persuaded the committee to accept a holding compromise. On his advice, the committee accepted the individuals making the applications as members on the basis that the applicants were exercising their options as members of an existing exchange, but the approval would be conditional on a later review of the deed of trust by the committee. Public confrontation was thus avoided and the dilemma of the criteria of membership was left for the incoming committee and the new commissioner to solve.

With John Bremridge, the Financial Secretary, I met the new committee with its officers at their inauguration ceremony on 3 December 1981. The dilemma was now on my table: the first wok to need attention. It was more than patching the wok; it was the preparation of the sort of stock exchange whose utility would become a crucial factor in maintaining Hong Kong as an international financial centre after 1997.

A crucial lesson I had learned in London from the amalgamation of the British and Irish stock exchanges was that membership was easily the most sensitive matter of any exchange. Membership is the basic bread-and-butter issue, defining the parameters of competition in a national monopoly market. But probably more than economics, membership carries the history of and the prejudices arising from the development of the exchange. It is about how members have worked together and their degree of trust in each other. The spirit of membership is almost as important as the material reward.

Taking note of this sensitivity in Hong Kong was essential, if only because at the end of the day any solution to the membership dilemma required a change in the articles of association of the exchange to be approved by a 75 per cent majority of the members. On the other hand, I was confronted by the interested London parties rightly concerned at the thought of losing their seats but taking comfort from their legal advisers who questioned the construction the Exchange Committee was placing on the law and the exchange's articles. On the other hand, there was this deep-seated and emotional resistance to change, even to the point of not recognising the changes which had already occurred in the individual exchanges and which were bringing new business for all members. My predilection was to gain the confidence of the committee. The majority had to be won.

Writing now, it is impossible to give the correct weight to the reasons behind the first change in attitude of the committee. I was fortunate that I took office in the middle of the bull market of 1979-82. Members are easier to convince about change when they are busy making money. I suspect also that the committee was beginning to feel more comfortable after a couple of months in office. Just before their formal inauguration, the committee had signed an agreement with the government under which the successful bidder for the Crown lease of what became known as Exchange Square would be required to assign to the government a floor area of some 4,000 square metres in the proposed building which would in turn be leased by the government to the stock exchange for its new trading hall and offices. The committee, looking to the eventual terms of that lease, may have considered it expedient to return a favour to the government. It may also have thought that a gesture of goodwill would be appropriate to the new commissioner who was publicly expressing a wish to apply regulation through and not against the exchange. By this gesture he would be placed in the position of 'owing a return'. Within the committee, Ronald Li must have resumed his persuasive ways. And, probably of most importance, the committee must have realised that while the Far East and Kam Ngan tickets ran, they would easily remain in control over a minority of corporate members. Woo Hon-fai and Ronald Li would be chairman on a revolving two-year basis as far ahead as they could see.

Whatever the motives, the breakthrough came on 21 January 1982, when Woo Hon-fai with his deputies Chan Siu-leun, Ronald Li, and Kenneth Wong called on me with a radical proposal. They agreed that the existing membership rules were riddled with a series of hidden arrangements. Some individual brokers were financed by an outside sleeping partner. More obviously, the position in limbo of corporate and foreign members was better resolved by agreement than by action in the courts. The new and radical proposal was that all hidden arrangements should be abolished. Instead, there should be an open and registered permission for partnership between members and between members and non-members even if the non-member was a partnership or company. The committee drew the line at participation by banks or deposit-taking companies. At the end of a most profitable discussion, the committee said that they considered they could bring the general body of members to the necessary favourable vote on a proposal along these lines.

The skilful Woo Hon-fai followed this approach by a series of letters. The substantive letter to me was to confirm our discussion, stating clearly:

> The Committee takes the views that membership should also be open to corporations, and reputable overseas dealers (corporate or individual) of substantial size. ... As the leading financial centre in South East Asia, Hong Kong should take pride in its open door policy. Participation by substantial foreign dealers will bring foreign capital and international expertise.

At the same time, on 3 February, Woo and his deputy chairmen wrote to the Financial Secretary and to the Secretary for the Civil Service to recommend that I should be appointed substantively as commissioner because, 'We sincerely believe that Mr. Fell's unique experience and expertise are invaluable to the Government as well as the securities industry here.' My first year had started on a most propitious note!

Unfortunately, the speedy solution which now seemed possible ran into the sands of bank participation in the market. Around the world the accepted barriers between broking and banking were changing. In 1982 in Hong Kong we were ahead of the international game in the permitted membership of our exchanges. Starting from scratch, but seeing the opportunities presented by the new exchanges, Fung King-hai had founded in Sun Hung Kai the company which became Hong Kong's largest broker. Ronald Li had started the revolution. Fung, more than any other single person, had brought share dealing to the general populace. In 1977 his stockbroking company was of such a size as to be itself listed, with a substantial capital and offices overseas. As an adjunct to the securities business, a finance company was formed which in 1982 had grown sufficiently to gain recognition as a bank. Sun Hung Kai next took in as partners the then largest international broker, Merrill Lynch, and also the French bank Paribas, which had already been part of the finance company. We had no need to look overseas: our own home-grown company presented under one roof the membership dilemma with all the possible complications.

In addition, Jardine Fleming, which locally was regarded as the merchant banking arm of Jardines, controlled a stockbroking seat in each of the three main exchanges. A second merchant bank, Schroders, also decided in 1982 to form a broking arm and took a seat on the Far East Exchange. (Schroders' action illustrated the latent hostility to change. Their first application was rejected by the balloting committee of the Hong Kong Stock Exchange which had been Schroders' initial preference.) As a further complication, the leading Japanese brokers, Nomura and Daiwa, were run as deposit-taking companies in Hong Kong, with their deposit-taking and securities business not separated either in management or accounts. To top off the problem, the Hongkong and Shanghai Bank decided to become stockbrokers in a most bizarre manner.

The Hongkong Bank, with their subsidiary, the Hang Seng Bank, formed a company with Evans Lowe to deal in securities and commodities. The first overseas member to be admitted by Ronald Li in 1979, Lowe owned seats on the Far East Exchange and the Hong Kong Exchange and his associate, Irene So, owned a seat on the Kam Ngan Exchange. Each of the seats had an entitlement to entry to the unified exchange. Peter Wrangham, appointed as chairman of the securities company, was at the same time the head of Hongkong Bank's Hong Kong operations, a permanent representative on the Hong Kong Association of Banks which fixed local interest rates, and with his office at the same address as the new company, Mansion House

Securities Limited. The venture was probably aimed at competing with Sun Hung Kai which had started in securities and had become bankers as well as being the largest broker in Hong Kong. The immediate effect was to cause a major alarm among the brokers, who envisaged all the branches of the Hongkong and Hang Seng banks channelling customer business through their own dealer.

This move brought a further complication. The Bank of China generally tried to emulate the operations of the Hongkong Bank, maintaining, for instance, through its sister banks the same size of branch network in Hong Kong. One of its sister banks, the Po Sang Bank, had had for a long time connections with the gold market. To match the new enterprise, this bank with another of the sister banks and a local broker, Mr. Cheung of the Kam Ngan Exchange, formed Chung Mao Securities and obtained a second seat on the Far East Exchange. I had the novel experience of officiating at the inaugural party of a stockbroker whose ultimate controller was the communist government of China. While it was amusing to reflect that only in capitalist Hong Kong was such an event possible, the reality was that our membership plot had materially thickened.

Times were also changing internationally and, in particular, in London as the brokers there began to sell themselves to American banks. Two large players in the Hong Kong market were immediately affected. Hoare Govett began to pass to Security Pacific Bank and Vickers, da Costa, at that time the most influential of the foreign brokers in Hong Kong, began to pass to Citicorp. At a minor level, Hong Leong Securities, with seats on two exchanges, was controlled by a Singapore group which had purchased the Dao Heng Bank in 1982.

Looking at stamp duty paid, we calculated that seats controlled by banks accounted for some 20 per cent of turnover. On this basis, it was clear that an agreement solely between the commission and the Exchange Committee was not a tenable solution. There had to be a solution which met all the diverse interests and which also retained some coherence in the Hong Kong market. The widest possible consultation was necessary to air the problem fully and by that process arrive, hopefully, at a consensus. The exchanges, individual brokers, banks, deposit-taking companies, lawyers, accountants, universities, and the polytechnic college were all invited to give their views. Written and oral evidence was taken. My own preference was for a stock exchange which, while meeting local criteria, would attract interest and investment from a securities industry which was rapidly moving to its predicted global basis. To gain acceptance of such a view, we needed and succeeded in stimulating a major debate.

In the end, with the agreement of the Exchange Committee, we were able in March 1984 to formulate proposals which became the basis of Hong Kong's own 'Big Bang' when the unified exchange was opened in April 1986. Through the wide consultation and preaching of our gospel, we had arrived at the necessary consensus. To gain the day, two concessions were made to the Exchange Committee.

In the first place, the committee held the strong view that no corporate member should stand for election for the committee. The commission decided that this sort of barrier was not a matter for legislation but could be dealt with in the articles of the exchange company. We took refuge in the fact that the committee's view was in line with company law in Hong Kong, which at that time prohibited a corporation itself from becoming a director of a company. We were content that corporate members would have full voting rights. There was, in any case, no head of steam from potential corporate members in 1984 for membership of the committee. A seat in the exchange was the pecuniary aim of potential members; a wider membership was the aim of the commission.

While we wanted Hong Kong to be an open market, we saw its economic purpose as meeting local and regional needs. For this reason we welcomed the mainland interest in membership and investment. The complementary overseas market at that stage was London, where the jobbers made markets in the principal Hong Kong stocks. London brokers, although the most active of overseas brokers, were nevertheless spasmodic in their trading in Hong Kong. As one London broker put it to the commission in oral evidence, they put their net down and caught the fish as the tide came in and then put down their net again when the tide went out. In other words, they took advantage of and encouraged the volatility of the market. Nomura had, in the dark days of 1983, taken the brave step of opening large new offices, but the Japanese and American brokers were more interested in trading their own domestic securities and operated in Hong Kong through local brokers.

The second concession was an agreement about the initial market share of bank-owned companies. The committee had put forward a variety of proposals to limit trading by these companies, all of which could, in our view, have been easily circumvented. In the end, the committee agreed that there should be no legal limitation. In return, the commission assisted in negotiating a voluntary agreement between the committee and the banks on the direction of business for an initial period in the exchange while mutual trust was generated.

By these concessions we had succeeded in the proposals we had envisaged at the outset. We proposed, and it was accepted, that membership would be on a mixed basis of sole traders, partnerships, and corporate members each with its own appropriate financial structure. Ownership could be foreign, but management had to be exercised through a registered Hong Kong entity. Any financial conglomerate member had to operate through a similar separate entity for its securities business. In August 1985 the Legislative Council put these decisions into legal form, and in April 1986 the new membership began to trade in the new exchange. The membership dilemma had been solved. The main ingredient for Hong Kong's eventual 'Big Bang' had been formed.

The work on this basic question stretched from 1981, when the dilemma emerged, until well into 1984, when the solution was generally accepted. Much more work was accomplished, mainly by the Exchange Committee supported by the commission. A floor slightly larger than London's had to be designed and constructed, with a trading desk for each shareholder and space for an outcry market. A vast communication system had to be installed. Above all, an acceptable electronic information system had to be invented in place of the much-loved chalk boards now impracticable with possibly 500 members trading.

It appears now as a smoothly conducted operation. In fact, the background from 1982 to 1984 was completely unsettled, encompassing a property and stock-market collapse, the murder of a banker, the suicide of a leading lawyer, the flight from the territory of two of his partners and a variety of developers, the defrocking and later imprisonment of the first chairman of the Hong Kong Commodity Exchange, the collapse of banks and indeed the currency, the negotiations with China, a major typhoon, and the visit of Margaret Thatcher to Beijing. As will be seen, the times were indeed interesting, but the commission had succeeded in the first of its major goals. The second but newly found goal was the matching of the stock market with a financial futures market.

PART II

THE DAVISON REPORT, 1988

The closure of the stock exchange in the aftermath of Black Monday led to the appointment of the Securities Review Committee on 16 November 1987 by the Governor, Sir David Wilson. The Committee, chaired by Ian Hay Davison, was asked to review the constitution, powers, management and operation of the Stock and Futures Exchanges and their regulatory bodies.

The Report of the Securities Review Committee on "The Operation and Regulation of the Hong Kong Securities Industry" (popularly known as the "Davison Report") was presented to the Government on 27 May 1988, recommending major reforms, including a fundamental revision to the internal constitution of both the Exchanges and the establishment of a single independent statutory body outside the Civil Service to regulate and supervise the securities and futures industry.

This chapter contains key excerpts from the Davison Report, beginning with a summary of the 1987 stock market crash, which was summarised in Appendix 1 - The Closure and Subsequent Events. This is followed by excerpts of Chapter 1: Overview, and Chapter 3: Objectives and Principles.

Establishment of the Securities and Futures Commission - the Davison Report

2

27 May 1988

The Closure of the Stock Exchange of Hong Kong[1]

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 may 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 facility[7], 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 Report[8]

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 unique[9]: 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 billion[10] 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 1987[13] 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 Exchange[15], 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 Principles[16]

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 1987[19] 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:

Index Contract	Exchange	$US billion
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 investors[20];
(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 China[24] 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 standrds 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 occuring. 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-jacketting the securities markets by a strict statutory regime which might all too easily lead to insensitive or heavy handed overregulation. 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 Sub-committee 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.

PART III

Building the Regulatory Framework

Following the Davison Report, the Securities and Futures Commission was established on 1 May 1989.

Robert Owen, the first Chairman of the Securities and Futures Commission, focused on building the regulatory framework.

His inaugural speech of 15 June 1989 explained the organisation, functions and powers of the newly formed Securities and Futures Commission (SFC), and its priorities.
The second speech touched on the regulatory philosophy of the SFC and pointed out that "... Hong Kong is still maintaining its tradition of light-handed regulation and non-interventionism by the authorities".

QW Lee, then Chairman of the Stock Exchange of Hong Kong, in his speech at the G30 Conference on Clearance and Settlement spelled out Hong Kong's readiness to upgrade its clearing and settlement system to G30 standards.

Robert Owen

3 Priorities of the New Securities and Futures Commission

IIR Conference on New Securities Regulations
15 June 1989

Introduction

The Securities and Futures Commission Ordinance passed its final reading in the Legislative Council on 12th April 1989 - $10^1/_2$ months after the publication of the Securities Review Committee's (SRC) report on the operation and regulation of the securities and futures industry in Hong Kong. Reconstitution of the Stock Exchange of Hong Kong (SEHK) already took place in 1988. That of the Futures Exchange (HKFE) was completed last month. Hong Kong cannot be accused of acting slowly to rectify the situation which followed the October 1987 crash. The government and the Legislative Council ad hoc group headed by the Hon Stephen Cheong and The Hon Ronald Arculli worked extremely hard and with great professionalism to meet the timetable set and to produce a fair, clear and comprehensible piece of legislation. The Securities and Futures Commission (SFC) commenced operation on 1st May - just in time, some people have said, in the light of subsequent events.

The Organisation, Functions and Powers of the SFC

The SFC has most of its senior management in place. Four Executive Directors head the four operating divisions - Ermanno Pascutto (previously with the Securities Commission in Ontario and the Toronto Stock Exchange) heads Corporate Finance; Robert Gilmore (from the Chicago Mercantile Exchange and previously with NASD and the Philadelphia Stock Exchange) supervises the Markets (including Exchanges and Clearing Houses); Bob Nottle (who will be addressing you after me and comes from the National Securities and Companies Commission of Australia) heads the Supervision of Intermediaries and Investment Products Divisions; and Gavin Edie takes on Enforcement as poacher turned gamekeeper, having previously spent 18 years in Hong Kong in accountancy, merchant banking and brokerage. These main Operating Divisions are backed up by support divisions - Legal Counsel, Financial Control and Information Technology, Personnel and Administration, and Communication Services. There is also a Director for Planning and Development, Barbara Meynert, who has played a key role in setting up the structure over the last nine months; and your Chairman today, our Senior Adviser on New Legislation, Geoffrey Lewis, who played a vital part in preparing and piloting the SFC Ordinance through, and is now continuing with the next and very important phase of legislative reform, which I will mention later.

A key element of the Commission is the five non-Executive Directors. They are Denis Chang, Thomas Chen, Denys Connolly, Frank Frame and Peter Wong. We are extremely lucky to have five of the most respected members of Hong Kong's business and professional community willing to play a central part in the work of the Commission. They collectively and individually provide a deep understanding of Hong Kong people and systems and a very broad and experienced perspective. I am sure they will either restrain any excessive or misplaced zeal on the part of myself and the other Executive Directors or goad us on if we show signs of lethargy.

In addition, the Commission will obtain advice on policy matters affecting markets and market participants from an Advisory Committee to which the Governor, in consultation with the Commission, has appointed twelve experienced and respected practitioners from different sectors of the securities and futures industries and related professions.

We are fortunate that a majority of the experienced staff of the former Office of the Commissioner for Securities (OCS) accepted our invitation to join the SFC. These, together with a somewhat larger number of external recruits have so far brought our team of executive staff up to around 70, against a budgeted figure of 100. Total staff number 148, against a budgeted 229. We hope to achieve full strength by around October. Generally speaking, we now have enough staff to deal with day-to-day work (of which there has so far been a great abundance), though not yet to undertake many of the tasks identified as necessary.

To give you an idea of what the SFC does, it may be helpful to review the roles of the four operating divisions in turn.

Corporate Finance Division deals with policy matters in relation to listing of securities, corporate disclosures, takeovers, mergers and corporate restructurings. In particular it:

- vets documentation in relation to corporate transactions including takeovers and mergers, public and private offers, placements, introductions, notifiable transactions, corporate announcements, etc. to ensure compliance with the Takeover Code, statutory Listing Rules, SEHK Listing Rules, placing criteria, and other requirements
- acts as the executive arm of the Takeover Committee
- reviews and updates the Takeover Code; inquiring into breaches of the Code and of the Listing Rules
- advises merchant bankers, the professions and other practitioners and intermediaries on requirements and application of the Takeover Code, Listing Rules and matters related to corporate disclosure
- ensures that listed companies are in compliance with the listing requirements
- reviews the SEHK Listing Rules and their application, including much liaison with SEHK.

Besides the responsibilities and powers under the Securities Ordinance (SO), the Stock Exchanges Unification Ordinance and the Commodities Trading Ordinance (CTO) for supervising the Exchanges, certain new responsibilities and powers are provided for in the SFC Ordinance. All these are exercised primarily through the **Supervision of Markets Division**, which is responsible for:

- supervising management of, and approving rules and regulations of, Exchanges and Clearing Houses
- monitoring trading activities, trading patterns and trends in Hong Kong and other markets, with a view to identifying and pre-empting potential problems
- monitoring control of risk in trading and settlement, including inter-market trading
- supervising the introduction of new clearing systems and depository arrangements
- monitoring, and where appropriate proposing changes to, trading rules and practices, e.g. margin requirements, rules relating to short selling, etc.
- ensuring the development of conduct of business rules and codes of conduct for dealers and brokers on and off the Exchanges
- supervising and promoting the sound development of securities trading activities in Hong Kong which take place outside the Exchanges e.g. the debt markets
- administering and supervising Compensation Funds
- reviewing and approving new products and services and associated practices, e.g. stock lending, new futures contracts, options.

Obviously many of these activities involve other divisions also.

The **Investment Products and Supervision of Intermediaries** Division spans a wide range.

The **Investment Products** Department recommends policy in relation to the regulation of investment management and advisory business and products generally. It covers two broad areas. First, it is responsible for regulation of the unit trusts and mutual fund industry by administering the Code on Unit Trusts and Mutual Funds. This involves:

- processing applications for authorisation (examining Memoranda and Articles of Association, Trust Deeds, Explanatory Memoranda, Custodian, Investment and Management Agreements, sales literature, annual and quarterly reports, etc.)
- making recommendations to, and preparing papers for, the Committee on Unit Trusts
- monitoring authorised unit trusts and mutual funds to ensure compliance and scrutinising proposed changes
- vetting advertisements and other invitations to the public to invest in trusts or funds
- responding to enquiries from the industry, the professions and the investing public.

Second, this department also exercises the Commission's responsibilities under the Protection of Investors Ordinance (PIO) in regard to:

- scrutinising and evaluating different types of Investment Arrangements (whether in relation to securities or other property) submitted for information, approval or authorisation
- ensuring that Certificates of Deposit, Commercial Paper, Paper Gold Schemes, Unit-Linked Life Insurance Schemes, Deposit Administration Policies and Pooled Provident Fund Plans comply with approved criteria
- monitoring the media for publication of investment arrangements and investment advice which is unauthorised or otherwise in breach of the PIO.

The responsibilities of the **Licensing** Department under the previous OCS regime were to deal with:

- applications for the registration and renewal of registration of securities dealers, commodities dealers, investment advisers, commodities trading advisers and their respective representatives

- Part VI of the SO and Part V of the CTO. There are currently 1,435 dealers (including 709 SEHK members and 83 HKFE members), 4,300 dealer representatives, 980 investment advisers, 482 investment representatives, and 269 exempt dealers and investment advisers

- suspension or revocation of registration
- processing of applications for exemption from registration
- administering the account and audit provisions in Part IX of the SO and Part V of the CTO. This mainly involves examination of accounts to check a dealer's compliance with the requirements to keep proper accounting and other records, to maintain proper trust accounts, and to observe the capital requirements in Section 65B of the SO.

In future, this department will, in addition to formulating licensing policy, carry out a number of new functions. It will:

- apply the new registration provisions in Part IV of the SFC Bill. This will require:
  - positive vetting of new applicants using the new "fit and proper" criteria
  - a full review of each existing registered entity against the new criteria
  - application of the new provisions concerning the maintenance of records by registered persons
- implement the SRC recommendation that exempt dealer status should be withdrawn. This will obviously increase the population of registered persons
- implement the SRC recommendation that share registrars should be licensed
- introduce other changes to the licensing system recommended by the SRC

- prepare documentation needed in connection with hearing of any appeals against refusal, suspension or revocation of registration.

The **Supervision of Intermediaries** Department is concerned with the monitoring of dealers, brokers and advisers. It:

- formulates policy on capital adequacy including the development of capital and liquidity rules for securities and futures businesses
- assists in the development of conduct of business rules
- monitors compliance with these rules by way of routine and special inspections of registered businesses
- liaises with external auditors and Exchanges to ensure better compliance with rules.

The **Enforcement** Division has two departments. The **Surveillance** group monitors trading activities in both securities and futures markets. This includes:

- monitoring unusual movements in prices or volumes and maintaining a "watch list" of particular shares
- undertaking preliminary enquiries into potentially suspicious price movements or trading patterns
- collecting data and maintaining a data base to facilitate investigations.

This is an area requiring increasingly sophisticated methods and technology to keep up with rapidly evolving markets.

The **Investigation** Department investigates alleged breaches of relevant ordinances and alleged misconduct by registered persons. Such investigations are generally based on referral from the Surveillance Department, other divisions of the SFC, the SEHK, the HKFE, complaints from the public or media reports.

Potential offences to be investigated include:

- creation of a false market
- employment of fraudulent or deceptive devices
- price fixing

- making false or misleading statements
- hawking
- incorrect offers to acquire or dispose of securities
- option or forward trading
- short selling
- incorrect handling of scrip
- exceeding of trading and position limits
- insider dealing.

The department prepares cases with a view to issuing warnings or advice, initiating disciplinary proceedings, initiating summary proceedings, or establishing a *prima facie* case for any indictable offences.

In addition to current responsibilities, the department will be required to enforce provisions of the Securities (Disclosure of Interests) Ordinance when this is brought into effect later this year and the proposed new Insider Trading law, when this has been enacted.

SFC Priorities

So much for the specific functions of the SFC. I would now like to say a few words about the priorities of the SFC as I see them. First, it is necessary to establish the strategic framework. This requires looking at the SFC from a very general or "macro" level in terms of its long-term purpose and objectives, its role in the governmental framework and its regulatory philosophy. We are in the process of producing a formal Strategic Plan, which is not yet complete or approved. I am therefore speaking a little prematurely and must stress that I am not enunciating finally agreed policies, nor dealing with the subject comprehensively. However, there are certain general points which I can make.

The overall role of the SFC is to ensure the maintenance of fair, efficient and orderly securities and futures markets in Hong Kong through effective regulation. The purpose of regulation is to create a framework which facilitates the soundly-based growth of markets and their long-term wellbeing, so that they can better perform their function of contributing to the creation of wealth and the economic and social development of Hong Kong. Views on the best means of achieving this general objective are bound to differ. Certain principles have, however, been identified as important in guiding the activities of the SFC:

- The main aim is to develop Hong Kong as a major international financial centre and the premier regional market for securities and futures trading and investment management. Despite recent events, I believe this still means (among other things) becoming, in due course, a central element in the financial infrastructure of China.
- The SFC will take account of the special characteristics and traditions of Hong Kong markets, local investor concerns and corporate structures and practices. However, the markets and their participants must maintain internationally acceptable standards. Future growth of our markets depends heavily on international involvement and interest.
- The SFC will encourage and assist the markets to develop responsible self-regulation.
- The SFC must keep a close rapport with and understanding of markets; both to identify and intercept problems and to encourage the development of new products, techniques and technology.
- The SFC must develop fast and flexible responses, it must be accessible to market professionals and users and consult interested parties appropriately.
- The SFC will concentrate its efforts on activity which really matters in the context of the objectives mentioned above.
- The SFC will try to avoid nit-picking but where it detects abuses it will act very firmly.
- The SFC will try to avoid complexity in rules and procedures, to the extent possible in each specific context.

- The SFC will always keep in mind the need to balance the benefits of regulation against its costs.

Against the background of these general principles, I would like to mention a few of the specific tasks and priorities of the SFC, as I presently see them, over the next year or two.

First there are **organisational priorities**:

(1) We will have to complete the formation of our team, both executive and clerical. We only started in January and there is still a great deal of work to be done here, in a difficult environment.

(2) The organisation needs to complete the process of "settling down", developing internal working relationships and administrative systems.

(3) Very importantly, we are undertaking a key project to develop systems and software to computerise the principal operations of the SFC, to establish easily accessible data bases and to apply computer-based technology to the performance of various functions. We have a mainframe computer due to arrive in October. One of the biggest handicaps of the OCS (which still afflicts us) is the slow, manual and paper-infested system for keeping and accessing records.

(4) We must develop staff training programmes.

Second, on the **operational** front. A vital general priority is to get all systems running as smoothly and efficiently as possible to deal with our day-to-day regulatory functions. Equally important is to extend and develop our already established working relationships with the management and governing bodies of the two Exchanges and Clearing Houses.

Some specific priorities (in no particular order) are:

(1) To introduce the new registration/licensing system. This includes drafting guidance notes on the "fit and proper" test for registered persons and developing systems to establish whether applicants meet them (including eventually, perhaps, recognition of certain examinations).

(2) To undertake a review of existing registered entities against the new "fit and proper" criteria. This will involve an on-going programme which will probably last three years.

(3) To devise and introduce new financial resources (capital adequacy) rules for financial intermediaries, to replace Article 65B of the SO and to extend capital adequacy supervision to futures dealers and other categories of registered person. These rules will need to take account of business volumes and different categories of risk. Extensive consultation with market participants and other regulators will be required. Introduction of the new rules will call for assistance and cooperation from the SFC to registered persons developing systems to meet the new requirements.

(4) To revise or develop codes of conduct for dealers and advisers covering their dealings with and on behalf of clients, disclosure of material interest, conflicts of interests, etc.

(5) To implement the discontinuation of exempt dealer status. This will involve consultation with relevant market organisations, other regulators and interested parties.

(6) To bring into effect the Disclosure of Interests Ordinance passed by LegCo last year. You will recall that this governs disclosures by major shareholders, directors and other connected persons of their holdings, purchases and sales above certain levels. This Ordinance has not yet been "triggered" because the necessary systems to ensure compliance with it are not yet in place. Manpower and computer systems are required in both the SEHK and SFC to collect and keep data, to monitor share movements and to distribute information to the market. This Ordinance, when it comes into effect, is likely to have a significant impact

on the modus operandi of listed companies here and their advisers.

(7) To review the new SEHK Listing Rules, which represent a comprehensive overhaul of the previous rules and are now in an advanced stage of preparation. Amendments will be necessary to the Statutory Listing Rules to accommodate the proposed changes.

(8) Related to these Rules is the issue of "re-domiciling" of Hong Kong listed companies. We are obviously concerned that this process, which has become increasingly popular, does not have the effect of allowing companies to avoid various HK statutory or regulatory provisions designed to protect the interests of shareholders in general. The SFC is working closely with the SEHK in considering measures to achieve this objective.

(9) To review the Takeover Code and the HK system for regulating corporate bids and deals.

(10) To oversee the introduction of the new Clearing and Settlement system for SEHK trades. This is probably the most important initiative currently taking place in the context of our efforts to increase the market's efficiency, improve risk management systems, reduce costs and increase the appeal of the market to international investors. The recent formation of the new Clearing Corporation, owned 50/50 by the SEHK and five major banks, is a very important step. Rapid implementation of the project must be the top priority for all those who are concerned with the long-term stability and growth of our market. This area lay at the core of the SRC report and is the most important field in which their recommendations remain to be implemented. The recent Group of Thirty Report also highlighted the importance of clearing and settlement systems and recommended international standards for markets to converge upon. The urgency of this project is not diminished by the fact that present settlement systems have survived the past three weeks. They remain cumbersome, old-fashioned, expensive and lacking in

effective discipline. We cannot afford to see implementation of the new system delayed.

(11) To assist in the introduction and subsequent enforcement of new legislation on Insider Trading. Attitudes towards insider dealing in markets across the world have shifted markedly in the past few years - from France to Japan and including many other countries. New and tough regulatory provisions have been introduced to combat this abuse, which increasingly impacts on the credibility of particular markets and investors' willingness to use them. As you know, a new Insider Trading Bill for Hong Kong is currently being drafted. You will recall that ExCo recommended two years ago that much stronger penalties should be introduced for insider trading, although it should not at this stage be made a criminal offence here. We at the SFC are obviously very much involved with this Bill.

(12) Very importantly, there remains the task of revising, consolidating and streamlining the numerous ordinances which deal with securities and futures (eight now in total, excluding the Companies Ordinance). In terms of the new legislation programme, the SFC Ordinance was only the first step. There remain a number of proposals of the SRC to be considered and implemented which involve legislative change. There are also numerous other improvements which have been identified as necessary or desirable. This is therefore a very major task which will require a great deal of effort by both Government and SFC.

(13) We have a number of tasks to undertake jointly with the HKFE. These include reviewing and completing the introduction of the new risk management system which accompanied the creation of the Futures Clearing Corporation last March; also reviewing the proposed new Interest Rate Futures contract.

(14) In the investment management area, we likewise have a full agenda. A priority task is to drastically reduce the queue for approval of investment products. We also contemplate a review of conduct of business rules for investment managers. This is

> an area where we hope in due course new self-regulatory mechanisms may develop. Members of the Unit Trust Association have taken an initiative in this direction, which the SFC welcomes. I believe it is likely to be some time, however, before any new bodies develop to the stage where they can take over the exercise of statutory responsibilities.

The above list of priorities is by no means exhaustive. I hope it gives you some idea of what we are going to be working on. We shall certainly not be short of things to do. If any of you would like to suggest additions to the list, I will welcome them during question time.

I would like to finish with a brief word about the impact on markets here of recent events in China. Although these have naturally cast a pall over all activities in Hong Kong and must have a major effect on the strategic thinking of all of us, the silver lining to the black cloud is that the market systems here have stood up extremely well. I have often in the past nine months been asked by senior visitors from overseas financial institutions how and when it will be possible to demonstrate that the market reforms of the past 18 months in Hong Kong have really worked. I have sometimes replied: "When we weather a major market crisis with all systems intact." I had not been wishing such a crisis upon us, at least not quite so early in the life of the SFC. However, it has come and so far the systems have shown no fissures. There was never at any stage even a twitch in the direction of closing either market. Trading has been very orderly; management at both Exchanges was clearly on top of the situation; numerous margin calls by the HKFE were made and fully met; other risk management procedures were maintained; surveillance of the financial position of brokers and dealers was close and capital replenishments were made where necessary; clearing and settlement systems showed no signs of clogging up. So far there have been no significant failures by brokers. Liaison between the exchanges and the SFC has worked satisfactorily. Unit trust redemptions have not created problems. I think it is fair to say that Hong Kong's markets and regulatory structure have shown a resilience, professionalism and maturity that was not present two years ago. I also believe this has been noted by international investors and regulators and will influence their attitude towards Hong Kong in future years, even though in the shorter term this positive factor will be outweighed in the minds of investors by the sharply increased perception of political risk.

ROBERT OWEN

4 Hong Kong Maintains Tradition of Light-Handed Regulation

The Securities Journal
October 1990

The SFC has existed 17 months. It feels like more. The number of developments which have occurred in that time, both of a regulatory nature and in the marketplace itself, is large by the standards of any market. It is easy to reel off a list of the achievements of the Stock Exchange and the SFC in the past year or so. Even easier to list the still considerable agenda of initiatives which remain to be completed. But that ground is covered in the SFC's recently published annual report. More interesting is perhaps to look at the regulatory philosophy of the SFC and to reflect on some of the issues which have been the subject of recent public debate.

Earlier this year, there was much talk of "overregulation" of Hong Kong's securities market. In Hong Kong more than elsewhere, public perceptions can easily be created by a spate of strong and sometimes not very analytical talk on the luncheon-cocktail circuit. Whether the charges of overregulation were aimed at the Stock Exchange, Government or SFC (and the latter was perhaps the most popular target), there does not appear to have been much evidence to support them. What I think prompted them was partly a natural human reaction to the rapid pace of change in the regulatory framework generally over the past three years, including measures which had been in the pipeline some time previously (such as the Disclosure of Interests Ordinance and the new Insider Trading legislation). It is true that much change was, of necessity, 'bunched' into this period.

However, an objective look at the current 'level' of regulation in Hong Kong relative to other markets (even allowing for the difficulties of making such comparisons) shows clearly that we are still very much at the lightly regulated end of the spectrum compared with other international markets, including others in this region. This is particularly true in relation to rules governing the conduct of business by brokers and dealers. While I firmly believe this is the right end of the spectrum for us to be at, I do not think many market participants realise the extent to which (relative to other markets) Hong Kong is still maintaining its tradition of light-handed regulation and non-interventionism by the authorities.

In the early days of the SFC, I also think fear of the unknown (and particularly the "foreign") played a part in influencing attitudes towards regulation. We have sought to address this through communication. I hope market participants now have a better idea who we are and what we are trying to do.

As stated in its corporate plan, the SFC is guided by the belief that the primary purposes of regulation are to ensure that the integrity of markets is maintained and that they grow and perform efficiently their function of facilitating economic development and the creation of wealth.

The SFC is particularly mindful of its statutory function to promote the development of Hong Kong's markets. Some financial markets derive their strength from the size and vigour of their domestic economies. Others from attracting international business through being open and providing more efficient, sophisticated, convenient services and products. Hong Kong is in the second category. Although the domestic economy is indeed vigorous, it is not large enough to be the engine for a financial market to the extent that the economies of more populous South East Asian countries can be.

The main potential source of growth (whether in fund management or securities trading) is regional and international business attracted to Hong Kong by the advantages it offers as a marketplace and regional centre. This includes particularly business related to

China. The attraction of international business can create a virtuous circle (as London found in the European context).

In the banking and fund management areas, Hong Kong has already become a fully international centre and prospered as a result. Although our stock market is moving in a similar direction, it is still only part of the way down the road. The moves towards internationalisation have inevitably set up certain stresses and conflicts of commercial interest. Similar stresses arose in other equity markets which have undergone a process of internationalisation. These should not cause us to lose sight of the strategic objective and of the long-term benefits for the great majority of market participants, and the economy as a whole, of succeeding in making Hong Kong the predominant international equity market in this region.

Key factors which will determine success in this effort are the liquidity of the market (in turn influenced by the range and number of investors and intermediaries, and the roles they play), the efficiency of trading and settlement systems, dealing costs (relative to other centres), the range and sophistication of products available, and confidence in the stability and fairness of the market. The SFC bears all these factors much in mind when considering its various decisions and actions. Hong Kong has many natural advantages (including its well-known entrepreneurial skills, superior communications, well developed range of professional services and the presence here of most of the leading regional fund managers). Unless it shoots itself in the foot by adopting narrow inward-looking policies, it is the natural choice to become the principal regional pole in an increasingly international market. This is perfectly consistent with continuing to trade a range of securities whose appeal is mainly local.

The SFC also takes very seriously its responsibility to promote the development of self-regulation by market bodies and firms. Unfortunately, there is considerable variety in the interpretation placed on the term 'self-regulation' by different market participants. Self-regulation of the type envisaged by the Securities Review Committee involves the voluntary maintenance by practitioners of high standards of business conduct (particularly in relation to the treatment accorded to investors) and willingness by market bodies to ensure that their members adhere to such standards, by (among other things) taking disciplinary action without fear or favour, or concerns about popularity, when lapses occur.

The independence and objectivity of the executive arm of self-regulatory organisations such as the Stock Exchange lie at the core of any self-regulatory system. So do the professional and ethical standards maintained within individual firms of brokers, dealers and advisers. The success of any self-regulatory system depends on the extent to which practitioners recognise that their own long-term interest is served by the maintenance of such standards, and that sacrifices in short-term profit are often necessary to achieve this. It is not easy to persuade practitioners to moderate the pursuit of short-term profit in this way in any market. It is a particularly challenging task for the leaders of the Exchange community in Hong Kong at the present time.

The SFC recognises that perfection cannot be achieved in any market, and changes in behavioural patterns occur slowly. Responsible self-regulation has taken many years to grow in the world's most mature markets and even then has shown lapses. This is one of the reasons for requiring a properly-equipped statutory watchdog. But the Commission is sincerely committed to encouraging the performance of real self-regulatory functions by the Exchanges and to the development of self-regulatory organisations in other sectors of the market.

The role of the SFC in relation to the Stock Exchange has been the subject of various public comments by Exchange representatives, particularly in the context of alleged overlap of functions. Actual overlap occurs in one area and is well on the way to elimination. The main roles of the Stock Exchange are to regulate and develop its market, to regulate the conduct of business and financial soundness of its members, and (in the listing area) to develop and administer listing rules which ensure correct and fair treatment for public shareholders. The latter function is sometimes mistakenly referred to as self-regulation; in fact it is regulation of other people (listed companies) on behalf of the investing public.

The Stock Exchange is a public utility, enjoying a statutory monopoly and financed predominantly by a statutory levy paid by investors and by fees paid by listed companies. In carrying out its functions it has an important duty (in common with exchanges elsewhere) to represent the public interest, particularly that of investors, and to act in the best interests of the market as a whole, irrespective of the interests of particular practitioner groups.

The SFC's functions include administering the licensing system for brokers, dealers and advisers (about a third of whom are stock exchange members), supervising the conduct of business and financial status of non-exchange members, regulating the offer of investment arrangements to the public, enforcing statutory provisions relating to securities and futures dealing, advising the government on legislation and administering the Takeover Code. In relation to the Stock Exchange, the SFC is a watchdog whose function is to ensure that the Exchange is effectively and impartially carrying out its regulatory and self-regulatory functions (for which purpose the Commission must keep itself properly informed and conduct occasional checks and reviews to establish how the Stock Exchange's systems are working).

The only area in which there is currently overlap of functions is in relation to listing matters, where historically the Office of the Commissioner for Securities exercised concurrently with the Stock Exchange the function of approving corporate transactions and documents. A major part of this overlap was eliminated in 1989 when the new Stock Exchange Listing Rules came into effect. The bulk of the remaining areas of overlap (mainly approval of new listings, rights offerings and other financings, and connected or very large corporate transactions) are scheduled to be eliminated during the next few months, subject to the conclusion of a Memorandum of Understanding between the Exchange and the Commission on listing matters and the satisfactory outcome of a review of the Stock Exchange's listing function which is currently under way. The SFC's objective is to reach a situation where the Stock Exchange is responsible for the day-to-day administration of all listing matters.

In general, the SFC is no friend of regulation for its own sake. Nor is the SFC in business to inflict punishment for technical peccadillos. Cases in which real abuse may be involved are still plentiful enough. We try to be flexible and practical, to adopt Hong Kong solutions rather than imported rules, and to remove regulatory controls wherever they do not serve a clear and useful purpose (and a considerable number of rules have been removed or relaxed in the past 17 months). On some important matters, however, we are not susceptible to compromise.

A feature I have observed in Hong Kong is that where personal or commercial interests of market participants are at stake, resort to the media tends to be a reflex action (and often finds a rather uncritical reception), arguments are more than usually prone to be simplistic or designed to appeal to instinct, and debate tends to focus on individuals rather than issues. This affects not only the SFC, but it has not simplified our first year of existence. We nevertheless try not to lose our balance. Nor are we deflected from the aim of maintaining the integrity of our markets here and promoting their development in the direction that will contribute most to Hong Kong's overall prosperity.

QW Lee

Group of Thirty Conference on Clearance and Settlement

5

14 March 1990

Hong Kong is in a special position among leading stock exchanges. It already has in place arrangements for very prompt settlement for transactions. The advantages of this situation are worth spelling out, all the more so, since some much larger exchanges have long operated on the basis of more generous settlement periods.

The major benefits of a minimal settlement period are its efficiency in reducing exposure to market risk and enhancing liquidity. In principle, equity markets should have the shortest possible settlement periods so that buyers take delivery and sellers receive payment promptly and with maximum certainty. This principle is neatly set out in the Report of the FIBV Task Force on International Settlement:

> "The objective is to reduce to the minimum the period of time between trade execution and settlement. The shorter the period, the greater is the reduction of all elements of risk. Settlement on the day of trade execution would therefore be a major goal, with perhaps on-line settlement the ultimate objective. As an essential intermediate goal the Group of Thirty's recommendation of a T+3 arrangement by 1992 is fully supported, except where a particular market already settles, or could settle, in a shorter period."

Hong Kong has traditionally adopted a 24-hour settlement rule. The existing system for share settlement in Hong Kong requires physical delivery between brokers. The massive movements of paper involve cumbersome procedures.

An additional complication confronts investors after settlement if they want immediately to secure the benefits and exercise the rights attached to the shares. The re-registration process takes up to 21 days before new shares are available. Our 24-hour settlement rule and the legal restrictions on short selling and stock lending effectively prohibit the sale of shares pending registration.

As a result, most shares are held in street names outside of books-close periods. They, thus, become, in effect, bearer shares, with registration highly concentrated immediately prior to the record date for dividends or rights. This system lacks security. It is prone to severe strain in times of high market activity.

In addition, as in other markets, the existing settlement system is widely perceived as a hindrance to the dealing system which has the capacity to cope with much higher volumes. The October 1987 experience emphasized these defects, although the need for a central clearing and settlement system was recognised well before that date.

The unification of the four stock exchanges, together with the introduction of computer-assisted dealing in 1986, resulted in a substantial increase in both trading volumes and in the level of international participation. The bull market of 1986-87 demonstrated that it can become almost impossible, for all trades to comply with the traditional 24-hour rule, even for transactions in which all the participants are local. Admittedly the 24-hour rule had not been rigidly implemented. The situation is of course not satisfactory.

However, choosing an ideal period which is of course longer is a complex business. Apart from anything else, we have to note that the more efficient operators - those participants able to settle comfortably under the current 24-hour rule - will be asked to accept a doubling (or more) of that period and a consequently greater market risk.

Thus, the Stock Exchange has been able to reach agreement in the spirit of compromise among almost all of its members to extend the settlement period to T+2. It is indeed a major achievement. Current statistics show that about 75% of trades are settled consistently on T+1, i.e. within the current rule. Thus, the majority of brokers and investors are geared to T+1. Frankly, our decision to extend the settlement period to T+2 could be seen as a step backward in the sense that it penalises the efficient majority of brokers.

So why did we agree to reverse directions? In an economy which prides itself upon being open and international, our instinct was not to just take a local view of the ideal settlement period, even though a very strong case could be argued for not shifting from T+1 to T+2. We also had to take fully into account the international investor and the impact of time zones on his settlement. For instance, we modelled a complex settlement case involving a fund manager in Sydney, an underlying beneficiary in New York, a global custodian in London and a sub-custodian in Hong Kong. Even in these worst-case circumstances, we are satisfied that settlement can normally be completed within T+2, assuming reasonably efficient and accurate processing.

As you would expect, we have lengthy and often spirited debates on this issue. Fortunately, we have found enough mutual goodwill to agree on a compromise. It is of course recognised that there are points of detail which are in the course of being addressed. The current position is that supporters of T+1 and advocates of T+3 or longer have agreed to T+2 which will be implemented after the systems of stock borrowing and lending and central clearing and settlement are satisfactorily in place. The implementation would be in the second half of 1991. A review of the T+2 system will then take place in six months' time.

In these circumstances, an obviously urgent priority has been to get in place a settlement system that would enable all participants to reduce the average time needed for settlement to a minimum. This goal was not a new one, of course. Provision of a central clearing system is an object of the Exchange, under its Memorandum of Association. But immediately after the creation of the unified Exchange, the first priority had to be the evolution of an integrated, smoothly-operating unified market in place of the four exchanges which had existed previously. At the same time, a computerised dealing system had to be put in place. These urgent tasks, inevitably, absorbed the bulk of the financial and managerial resources available.

The crisis created by October 1987 altered priorities dramatically. Settlement problems were brought out from back offices and became news headlines. The need for a central clearing system became overwhelming.

The initial response was the Clearing Project, organised under the Exchange's interim Management Committee and guided by Mr Robert Fell, who you all know is a member of the G30 Steering Committee on Clearance and Settlement. Although funded and, initially, staffed by the Exchange, the Clearing Project was a separate entity supported by all the major market participants. This arrangement had the added benefit of ensuring full participation by all interested parties and was supported by a series of consultative working parties composed of brokers, custodians and registrars. By May 1989, the process had progressed sufficiently in identifying both the problems involved in the system and their solution, for work to begin on putting together a new system.

The work was taken up by the Hong Kong Securities Clearing Company Limited (HKSCC) formed on May 5, 1989 as a not-for-profit organisation limited by guarantee. Continuing the arrangements of the Clearing Project, the Exchange provided the funding and is responsible for 50% of the guarantee with the remaining 50% being shared equally by five of our premier banking institutions: the Bank of China, the Bank of East Asia, the Hang Seng Bank, the Hongkong and Shanghai Banking Corporation and the Standard Chartered Bank. The Board also reflected the consultative stance of the Project, being composed of 14 members, five from the Exchange, one from each of the bank shareholders, together with a representative each from the custodians and the registrars and the Chief Executive of the Exchange and HKSCC as ex-officio members.

For the long run, we believe the new settlement system will eliminate the time factor. By the third quarter of 1991, we expect to have up and running a central clearing and settlement system based on two concepts: centralised broker-to-broker net settlement; and book-entry delivery and transfer of uncertificated shareholdings. Existing trading practices will not be affected. Trading data will be transferred by the Exchange to the HKSCC for processing after close of the market on trade day. Electronic links will connect up all participants. Money transfers will be through the established banking system. HKSCC will guarantee all trades in Hong Kong stocks on the Exchange locked into the system at the time of trade data transfer.

Out of the nine recommendations made by G30, Hong Kong will be able to comply with seven in full and one in a slightly modified form, i.e. T+2 instead of a T+3 rolling settlement period. The only recommendation that will not be considered at this stage is the second, because, initially, HKSCC will admit only brokers and custodians as members. All indirect market participants including professional investors will settle through brokers and custodians. It is hoped that the private sector will offer a trade comparison facility to indirect market participants, or at least to institutional clients, by some time in 1992.

Hong Kong is, therefore, in a unique situation. Whilst other exchanges are attempting to compress their existing settlement periods to reduce market risk, Hong Kong proposes rationalising its settlement rules by an extension of the settlement period.

We note that it is not explicit in the G30 recommendations whether T+3 by 1992 is a final goal or is itself an interim step to a shorter period or even on-line settlement. For us, it is an article of faith that the shorter the settlement period the better. Thus, we in Hong Kong see ourselves as running ahead of, rather than against the rest of the field. We are confident that our own efforts to achieve minimal settlement periods, even when faced with drastic institutional reorganisation and very volatile market conditions, are a demonstration of the way in which short settlement periods are a realisable goal, useful indicators of market efficiency and a valuable safeguard for participants.

PART IV

Reform and Development

Robert Nottle served as the first Deputy Chairman of the Commission in 1989. He continued with institutional building when he became Chairman of the Securities and Futures Commission in 1992. The reform and development of the securities industry took on a more regional and international dimension, as the opening of China's economy in the early 1980s presented both challenges and opportunities to the growth of the capital market in Hong Kong.

In his speech of 25 September 1992 in Beijing , Robert Nottle examined the factors that a country should consider in deciding on the appropriate regulatory structure for the securities and futures industry. He emphasised the importance of the quality and experience of the members of the regulatory authority and the need to equip them with adequate resources. His second speech described the development of the securities market in China, the regulation of the equities market, and the listing of Chinese enterprises in Hong Kong. In his article for Capital Asia in 1993, he recorded the role played by the Commission in developing the various segments of Hong Kong's capital markets during the period 1992 to 1994.

Robert Nottle

6 Choice of Structure for Regulating Securities and Futures Markets

Conference on Developing Securities Markets in China
Beijing, 25 September 1992

Introduction

I am honoured to have been asked to speak at this Conference and to be able to offer my thoughts on the development of an administrative structure for regulating securities and futures markets in China. Before doing so I would like to congratulate the State Council on its decision to establish a regulatory authority since it is important that those operating in the markets clearly understand that there is a regulator, who that regulator is and what that regulator does. I hope to share with China some of Hong Kong's experiences, both our successes and our mistakes, just as Hong Kong has shared in the diversity of experiences from other markets.

Of course Hong Kong's regulatory structure is only one amongst many systems which exist throughout the world. I think it is fair to say that the diversity of structures indicates that there is no unambiguous answer to the question of what is the most appropriate regulatory model for any particular country. If one goes behind the choices that have been made by various countries we tend to find that, more often than not, the establishment of a new regulatory authority is a response to a market crisis, and that the administrative system adopted for regulatory purposes is heavily influenced by domestic historical and political considerations.

This is certainly true of Hong Kong, which decided to establish its independent statutory market regulator, the Securities and Futures Commission (SFC), in the wake of the 1987 stock market crash. Hong Kong's decision to establish a regulator independent of government in the form of a corporation run by a board of directors was to a large extent a product of the failure of the administrative structure previously in existence to regulate the securities and futures markets. Although the main problem with Hong Kong's previous administrative structure was that it was understaffed and underfunded, the magnitude of the problems that surfaced in 1987 prompted Hong Kong to adopt a fresh approach. Likewise, in the United States, the Securities and Exchange Commission and the securities regulations which it administers were established during the early 1930s in the wake of a series of market abuses and malpractices throughout the 1920s.

China is truly fortunate not to be in such a dramatic and reactive situation.

In deciding on the most appropriate administrative structure for regulating the securities and futures markets in any particular country, I believe that there are a number of dimensions which have a significant influence on the final outcome. These include:

- domestic political and historical considerations, including the role of the central government *vis-à-vis* other tiers of government, especially provincial government;
- the nature and relative importance of the existing bodies which regulate financial services or other economic activities;
- the stage of development which has been reached by self-regulation and the extent to which government views self-regulation as a viable part of the system; and
- the geographic size of the country, which determines whether or not the regulatory authority has to establish regional offices.

The system of regulation which ultimately emerges will be the outcome of the interaction of these various dimensions. The process of choice is rarely a smooth one because there are usually conflicting considerations and many of those involved in the decisions will have positions which they will wish to protect or expand.

As I mentioned a moment earlier, there is significant variation between the systems which have been established to regulate the world's securities markets. Having said this, most of them do seem to function fairly smoothly. So I am not here today to tell you what the best system is for China; only to discuss some of the factors that must be considered when choosing between the alternatives. However, I must emphasise that we should never forget the human factor. The performance of a regulatory authority depends not only on the administrative structure in which it functions but it also depends most importantly on the quality and the experience of the persons who work at the authority as well as the extent to which those persons are provided with adequate resources. It is most important that some of the staff have practical experience - you have a saying for this - "Talking to a scholar for a night is better than reading for ten years".

In deciding on the appropriate administrative structure for regulating the securities and futures markets in a particular country, at the very least it is necessary to address the following matters:

- The nature of the body or bodies who will undertake the regulation;
- The activities which are to be subject to regulation (which involves decisions about the classes of persons who will be regulated);
- The functions and powers which are to be given to the regulatory body; and
- The form in which the regulatory requirements are to be mandated.

These matters tend to be interactive or interdependent, although for illustrative purposes I will discuss each in turn. During the process I will refer to regulatory structures which have been established in various securities markets, with particular reference to Hong Kong, Singapore, Australia, Canada, the US and the UK.

First, the nature of the body or bodies who will undertake the regulation.

In making this decision there are a number of different models to choose from. As I mentioned earlier, in Hong Kong we have a regulatory body which is a corporation run by a board of directors and which is relatively independent of Government. Although this scenario has proved very workable for Hong Kong, and has the advantage of freeing the Government from the need to become directly involved in the controversial issues which arise during day-to-day regulation of the securities and futures markets, it does not mean that Government is totally removed from the regulatory process. For one thing, independent or quasi-government bodies cannot make legislation. In Hong Kong, a Government Department, the Monetary Affairs Branch, sponsors new legislation which is proposed by the SFC and which has to be put before the Legislative Council. The SFC is also dependent upon the Governor for the approval of its annual budget. Furthermore, before the Commission can use some of its significant supervisory powers, for example, to direct the exchanges and clearing houses to take certain action, we must first consult the Financial Secretary and receive his tacit approval - or at least a no objection. In the final resort the Governor is able to give directions to the SFC.

At the opposite end of the spectrum is the model under which a Government Department, such as a Ministry of Finance, regulates the securities and futures markets. This is the situation in Germany and Japan, although Japan has just made changes to these arrangements by injecting into its system certain elements from outside Government. On 20 July a Securities and Exchange Surveillance Commission was inaugurated within the Ministry of Finance with two main responsibilities - the investigation of unlawful conduct which might undermine the fairness of the market and the inspection of securities firms. The Commission is composed of a Chairman and two Commissioners appointed from outside the Ministry and there is an element of independence in that the Commission is not under the direction or the supervision of the Ministry of Finance. This structure is a response to criticisms that Government has been too close to the day-to-day problems of the Japanese market.

Somewhere in between the two models mentioned above lies the approach adopted by many countries under which a "Securities Commission" is established with its own charter but usually subject to direction from a Minister. The staff tend to be career civil servants. This is the approach adopted by the (Federal) Governments in Australia, France, Italy, the Netherlands, New Zealand, Spain and the United States.

In Canada the Federal Government does not regulate the securities industry on a day-to-day basis; instead separate provincial authorities have been established, mainly because of long-running historical and constitutional factors. This used to be the case in Australia until Federal Government control evolved over the decade of the 1980s. There is some fear at the provincial level in Canada that this process has started there too.

Singapore has adopted a model different from any of those described above, in that its securities and futures markets are regulated by a central bank, namely, the Monetary Authority of Singapore (MAS). Like some other central banks in the world the MAS is not a Ministry but is a quasi-Government authority governed by a board of directors who are accountable to the Singapore Government.

The UK has a complicated system involving a mixture of Government Ministries (the Treasury and the Department of Trade and Industry) and independent regulators, viz. the Securities and Investment Board (SIB) and the Takeovers Panel. The SIB is a corporation established by statute and governed by a board of directors which has delegated its authority to a number of "Self-Regulating Organisations" (SROs) with specific areas of authority - these include agencies to regulate securities and futures dealers, investment management companies and life insurance and unit trust organisations. The Takeovers Panel is a non-Government regulatory body originally established under the sponsorship of the Bank of England and which administers a non-statutory code of regulations. The UK system is underpinned by sophisticated financial systems and by sophisticated participants who have had to make a substantial commitment both in terms of funding and time taken to participate in the regulatory process.

In my opinion the fewer departments and bodies that are involved in the regulation of the markets, the better. Having numerous regulatory bodies tends to slow the response time of regulators to market developments and initiatives, and tends to create duplication of regulatory effort, which can prove frustrating to both market practitioners and regulators alike. Where there is more than one regulatory body, there needs to be a very clear demarcation of function to minimise problems associated with overlaps of and gaps in responsibility. The immediate past Chairman of the SIB has expressed concerns about the fragmented nature of financial regulation in the United Kingdom.

A further point is that in countries such as China, Australia and Canada, which are geographically large, regulation will normally have to be conducted on some form of regional basis and this raises difficult issues concerning the relationship between regional regulatory authorities and the central authority. Even if there is a Head Office/Branch Office administrative structure, there will be a tendency for Branch Offices to drift away from following the Head Office requirements. The relationship needs to be carefully managed. If there is no central authority it almost certainly follows that regulatory requirements will differ, sometimes significantly, from region to region. In my opinion this situation should be avoided if at all possible because it will almost certainly lead to forum shopping whereby persons who are subject to regulation shop around regulators seeking out the decision which suits them best.

The last point I would like to make concerning the nature of the body undertaking the regulation concerns the structure of the decision-making process.

In some commissions the functions and powers of the organisation are vested in the commission as a whole, which is what I call the "collegiate" approach - in others it is vested in the chairman, which is what I call the unitary approach. I have a strong preference for the collegiate approach as it requires some form of consensus to be reached. Although the process of reaching consensus can be frustrating, it usually ensures that all views are taken into account. The unitary approach can be confrontational and can produce policies which do not properly balance the various interests of market participants, market integrity and market development. It is most important that the decision-making process incorporates a mechanism to enable those who are subject to regulation to be involved in the development of policies. In order to formalise this process many regulatory authorities appoint advisory boards composed of senior representatives from different areas of the industry.

I now turn to the *second major issue* which I mentioned earlier - *the activities that are to be subject to regulation, which also involves decisions about the classes of persons who will be regulated.*

There are three basic areas of regulation which might be considered, namely, regulation of securities markets, regulation of futures markets, and regulation of the internal affairs of corporations. The first two include as a subset the regulation of persons active in those markets, such as market intermediaries and controllers of listed companies. The third includes as a subset the regulation of directors of corporations.

At the highest level, a decision must be made as to whether all three of these areas will be regulated. Most countries do regulate all three, but it is open for consideration as to whether one regulatory authority should be responsible for regulating all three, or whether the responsibility should be dispersed. If a country is in the fortunate position of starting with a clean slate, there are considerable advantages in having all three areas regulated by one body, especially as there is so much overlap between each.

At the very least it is desirable to have one body regulating both securities and futures markets. In the US, there are two separate national agencies regulating securities and futures. With the development of innovative financial products, overlaps and uncertainties inevitably emerged and these have created on-going "turf battles" and the need to establish an official accord between the two regulatory agencies. Most countries have avoided these problems and have adopted an administrative model whereby the regulation of securities and futures markets is conducted by one agency.

A similar problem area arises when the administrative model which is chosen makes it necessary to draw a distinction between regulating the securities activities of a company and regulating its internal corporate affairs activities. It is hard to draw a hard and fast line here, but generally speaking securities regulation focuses on ensuring adequate and timely *disclosure* to the market about a wide range of matters concerning the operations and management of a listed company while corporate affairs regulation imposes restrictions on the transactions the management can enter and regulates the relationship between controlling and minority shareholders. Most securities regulators find that disclosure alone is insufficient to prevent conduct by companies that can affect market confidence and need to have rules that at least require shareholder approval of certain types of transaction. Most countries have this problem because they have decided to separate the regulation of these activities. Furthermore, I think many of them made this decision more or less by default - with the growth of public limited liability companies most countries established "Company Registries" which, over time, developed into corporate regulators. As I said before, securities regulators were often established as a political response to a market crisis and so separate regulatory bodies emerged. Be this as it may, establishing separate agencies for regulating securities matters and corporate matters creates problems. For example, in the area of corporate takeovers, which are usually times of intense activity for management, actions by directors which are not in the best interests of minority shareholders can constitute a breach of Takeovers Regulations (usually a securities regulator's function) and also a breach of directors' duties (usually a corporate regulator's function). Australia is one of the few countries in the world where the central regulatory body looks after both the regulation of the securities market and the regulation of the internal affairs of companies and is therefore able to consider such matters in an integrated manner. However, Australia is an exception with most countries falling into the evolutionary trap I mentioned earlier.

Although China already has a number of ministries at the national and provincial level who are involved in regulating companies and securities, the fact that China's regulations concerning corporate affairs and securities are still in their very early stages gives China the advantage of a relatively clean slate. Whatever is decided, I would urge you to think seriously about choosing regulatory models which maximise integration and minimise fragmentation.

I would now like to focus on the *third major issue*, namely, *the functions and powers to be given to the regulatory body.*

This of course depends to a large extent upon what areas one expects the agency to regulate. For the sake of simplicity I will assume for the moment that we are considering the functions and powers of a securities and futures regulator. In general, such a body will be expected to seek to maintain the integrity of the market, to protect investors and to ensure that the markets develop along sound lines. At the very heart of these functions is a mission to engender confidence that persons, who incur obligations will meet those obligations, or if they don't that there is a means of enforcing them to do so. The integrity of this process is a fundamental cornerstone of any well-functioning market.

To carry out these functions regulators generally have powers to oversee the exchanges and clearing houses through which the markets operate - if we think of a theatrical performance, this is regulation of "the stage". They generally also have powers to oversee the "actors" who play on the stage, including issuers of securities, market intermediaries such as brokers and investment advisers, and their customers.

In terms of regulation of the stage, the usual practice is for the regulator to approve the setting up of the stage, i.e. the exchanges and, thereafter, to oversee changes to the rules relating to how the exchange is to be governed, what is going to be traded, and how the trading and settlement will be conducted.

These oversight mechanisms are the means by which the exchanges are required to demonstrate to the regulator that they have the operational capacity to conduct trading, that they have in place the systemic controls to contain the risks posed by trading, and that they have the controls in place to appropriately regulate both the corporations who wish to have their securities traded and the members of the exchange who wish to deal (both in terms of their dealings with each other and in terms of their dealings with clients). By its power to withhold its approval of rule changes, the regulatory body is able to ensure that the proper controls and risk management structures are in place.

This leads me to a discussion of the role which the exchanges themselves might play as self-regulators. Self-regulation is basically the supervision of an activity by those who participate in the activity - in this case trading in securities or futures. The major advantages of self-regulation are the market experience and expertise that is brought to bear on the regulatory process and its inherent flexibility. Too frequently the Government regulator lacks such expertise. However, effective self-regulation requires appropriate rules, common acceptance of professional standards and the acceptance that such standards must be upheld by fair and firm disciplinary action when they are breached. In my view the development of self-regulation by the exchanges in China should be actively pursued at the same time as the development of statutory regulation. The two processes complement each other.

The regulation of the "actors" on the stage is in some respects more complex, as they are more diverse. In so far as market intermediaries are concerned, regulators usually focus on their entry to and exit from the market (by means of licensing requirements which set minimum standards), as well as their on-going conduct whilst they participate in the market. The objective is to ensure that market participants generally, and investors in particular, have confidence that the people and organisations with whom they deal are efficient, honest and financially sound, and will treat them fairly.

As for the regulation of issuers of securities, it usually takes the form of establishing requirements concerning disclosure not only at the time of the initial offer, but also on an on-going basis - and of establishing structural requirements relating to the internal operations of the issuer - these cover such things as a minimum track record prior to listing and the minimum size of the public float, etc. This ensures that the market is informed of the intrinsic value of the product that they are dealing in and also sets minimum standards concerning shareholder rights and the structure of the issuing vehicle.

The regulation of issuers also includes the supervision of issuers of collective investment schemes, which also takes place by means of both disclosure and structural requirements, for example, in relation to the form the scheme can take, the role of an independent agent to monitor the scheme, and restrictions and regulations concerning the type of investments that can be undertaken. In most jurisdictions a cornerstone of regulating issuers of public offers of securities and collective investment schemes is the pre-vetting of disclosure documentation prior to the issue or the listing. I am pleased to see that China is adopting this cornerstone.

A further element of the regulation of issuers is the regulation of the process whereby changes take place in the control of a corporation, i.e. regulation of takeovers and mergers activity.

In terms of powers granted to regulators, the most controversial tend to be those related to enforcement - that is, the extent to which the regulatory authority can investigate those who are subject to regulation and take remedial action when things are found to be wrong.

Generally speaking, securities regulators have wide powers to collect information and to conduct enquiries, including investigatory hearings, into the financial position and the market trading activities of intermediaries. More difficult and controversial are the nature and extent of the powers which the regulators might have to investigate the affairs of listed companies and their managers and controllers, and also the nature of the remedial actions open to the regulatory authority if something is found to be wrong. It is my experience that it is in this area of "corporate fraud" in respect of the affairs of corporations where the potential losses to shareholders and creditors are the greatest but where investigatory and remedial powers are sometimes the most limited.

Another of the major issues for consideration concerns the *form in which the regulatory requirements are to be mandated.*

Broadly speaking there are three major choices:

- statutory, where the requirements are ensconced in law;
- non-statutory codes or guidelines, which do not have the force of law and which depend for their effectiveness upon the willingness of market participants to abide by them; and
- listing rules and broker conduct rules of exchanges and SROs which depend for their enforceability upon the existence of a contractual arrangement between the issuer or the market participant and the exchange or SRO making the rules. Such an arrangement gives the regulator leverage over the regulated; for example, an exchange can threaten to delist or suspend the trading of the securities of an issuer which does not abide by its rules, or impose a monetary penalty or remove the ability to trade in the market from a member who is in breach of the rules.

Most regulatory regimes have a combination of statutory regulation and exchange/SRO rules. The role of non-statutory codes and guidelines is usually, although not always, *de minimis*, because such requirements are difficult to enforce with any degree of certainty. Naturally, for non-statutory codes and guidelines to be effective in the long term, a co-operative spirit must have taken a firm hold, and there must be strong common standards of appropriate market behaviour and practice.

Another question relating to the form of the requirements is whether they are drafted broadly in the form of general principles, or whether they are drafted as very detailed and specific regulations. If the requirements are drafted as general principles then there is the benefit of them being flexible and quickly adaptable to changing market situations and new products, but there is the disadvantage that they might not be specific enough for particular market situations. The Hong Kong Code on Takeovers and Mergers relies on a number of broad, general principles of how changes in corporate control should be conducted, while at the same time using explanatory notes to provide market participants with an idea of how these principles are interpreted and applied in various situations. Such explanatory notes need constant updating and revision to take into account new market circumstances. As the Code is non-statutory it can be easily amended, but such a process would be much more cumbersome if the Code was enshrined in legislation.

Conclusion

As you can see, the question of which regulatory structure is best suited for China's needs and circumstances is a complicated one. I hope that by raising some of the key issues I have been able to shed some light on the choices which are open to you.

Robert Nottle

7 The Development of Securities Markets in China in the 1990s

Asiatic Friendship Association and Institutional Investors
Geneva, 21 June 1993

Background

Following the Communist Party's accession to power in October 1949, securities markets in China went into a prolonged period of stagnation, as stock markets were closed and new issues dried up.

The re-emergence of securities markets commenced under the auspices of the economic reform programme of "socialist modernisation" announced by then party Vice Chairman Deng Xiao Ping in 1978 under which market forces would be brought to bear on the economy and China's "doors would be opened" to foreign capital and entrepreneurs. Deng described the new policy as "socialism with Chinese characteristics". The development of securities markets was intended, amongst other things, to extricate the PRC Government from the funding problems arising from substantial budget deficits due in part to the heavy subsidies granted to loss making state-owned enterprises. In addition, it was thought that securities markets would enable state enterprises to mobilise and efficiently allocate the huge amount of domestic savings which is estimated to be in the region of US$200 to US$300 billion. As part of the process it is hoped that exposing state enterprises to the rigours of the capital market will improve internal management and raise productivity.

Following Deng's announcement, the PRC Government in 1981, after a break of 30 years, resumed issuing government securities. At first, State Treasury Bonds were issued to various government institutions and enterprises and then, in 1984, permission was granted to some enterprises to issue bonds and shares to the public through approved financial institutions. Individuals were first "permitted" to purchase treasury bonds in 1982 through the enterprises for which they worked under a system whereby purchases were compulsory and formed part of the employees' total compensation. Circulation and trading of these bonds were prohibited. China opened its treasury bond market in 1988 when underwriting by non-financial institutions was permitted and it became possible for bondholders to trade their securities. Marketability and liquidity developed with the opening of treasury bond circulation markets in 54 cities. Recently, the Chinese Government has had difficulty in selling a 41-billion RMB treasury bond issue at current rates. The State Council responded by issuing a circular to the effect that there is to be no "public offering" of debt or equity until the bonds have been sold.

The authorities are currently planning the development of an RMB commercial paper market, while bonds and commercial paper targeted at foreign investors are also on the drawing board.

In order to facilitate the development of securities markets a number of experiments have been conducted over the past decade. One experiment involved the introduction of the joint-stock company system, which was regarded as a prerequisite to the establishment of markets for securities. In September 1984, the first joint-stock company was established under this system (Tianqiao Department Store in Beijing). The introduction of the joint-stock company system commenced in Shanghai in 1985 and in Shenzhen in October 1987.

Another experiment consisted of establishing securities trading markets. This occurred in 1986 when the People's Bank of China (PBOC), Shanghai branch, sanctioned the Industrial and Commercial Bank of China to establish an over-the-counter (OTC) market for bonds and shares. In 1988 shares in the Shenzhen Development Bank were traded on the Shenzhen OTC market.

On 19 December, 1990, the Shanghai Securities Exchange was officially opened for trading to replace the OTC market, while the official opening of the Shenzhen Stock Exchange took place on 3 July 1991. At present these two securities exchanges are the only two authorised Exchanges operating in the PRC, although there has been pressure at the Provincial level to establish more. The trading of shares on the Shanghai and Shenzhen exchanges is limited to securities listed thereon, while unlisted securities continue to be traded on OTC markets located in various major cities around China. At first, shares on both the exchanges were offered only to mainland Chinese investors and were denominated in RMB. However, in 1991, China's securities markets took a major stride forward with the removal of restrictions on foreign investors acquiring shares of Chinese enterprises. This was accomplished by permitting listed companies to issue a special class of shares, "B" shares, the purchase and sale of which is limited to foreign investors. The first "B" shares were issued by Shanghai Vacuum on 20 January 1992 in Shanghai and commenced trading on the Shanghai Securities Exchange on 21 February 1992. The Shanghai Securities Exchange and the Shenzhen Stock Exchange are the only two facilities through which "B" shares can be traded.

To improve the efficiency of the Chinese securities markets further, the Stock Exchange Executive Council (SEEC) was formed in March 1989 to create a nationwide treasury bond trading system (Securities Trading Automated Quotations System (STAQ)) which was established on 5 December 1990. Initially, STAQ linked approximately 30 cities and 80 licensed trading corporations in China, with an average monthly turnover of over RMB600 million.

Since the first stock market experiments were carried out in Shanghai and Shenzhen, these two cities have promulgated a series of rules and regulations, covering such matters as the management of joint-stock companies, stock issuance and trading, and securities firms and stock exchanges. Some rules have also been formulated in other Provinces and cities. However, the absence of a comprehensive legal and regulatory framework for the securities industry impeded market development initiatives and prompted the Chinese government to embark on an energetic campaign to address these deficiencies. The Central Government encouraged the foundation of the Securities Association of China (SAC) in August 1991 and in late 1992 established the State Council Securities Policy Committee (SCSPC) and its operating arm, the China Securities Regulatory Commission (CSRC), which is currently working on legislation to establish corporate and securities laws in China.

A further experiment being conducted to develop China's securities markets is the conversion of major state-owned enterprises into joint-stock companies and the listing of the securities on exchanges both within and outside China, including Hong Kong. The first batch of these enterprises has been chosen and listings are likely to proceed from the middle of 1993.

Having set the background to the development of securities markets in China, I now propose to examine:

- The nature of the instruments traded on the markets.
- The issue and secondary trading of securities.
- The equities markets in Shanghai and Shenzhen.
- Regulation of the equities markets.
- Listing of China enterprises in Hong Kong.

Nature of Instruments Traded on the Markets

So far, PRC securities markets have been dominated by bond transactions which account for over 90% of the total volume of all trading that takes place. As previously mentioned, trading other than on the two authorised exchanges is conducted through the OTC markets and the STAQ.

At present there are four major types of bond issues - Treasury Bonds, Construction Bonds, Enterprise Bonds and Financial Bonds.

Quantitatively, *Treasury Bonds* are the most important fixed interest security. They are issued by the Ministry of Finance's (MOF)

State Debt Management Department and are floated to cover budget deficits and to raise funds for large domestic construction projects. Interest is paid in full at redemption with no interim payments. *Construction Bonds* are issued by enterprises or government agencies (or by the MOF on their behalf) to finance special investments in major construction projects or infrastructure projects. *Financial Bonds* are issued by specialized banks as an additional source of funding, distinct from the customary sources such as deposits, central bank credit and budgetary loans. Usually, the proceeds of bond issues are designated for specific uses such as supporting finance projects, etc. Unlike interest on Treasury Bonds, accrued interest on Financial Bonds is payable annually. *Enterprise Bonds* are those issued by "trading enterprises" to supplement general revenues and to extend budgetary financial support.

In addition to the various forms of bonds, there are four major types of stocks. They can be categorised according to their ownership, namely State Shares, Legal Person Shares, Individual Shares and Foreign Investment Shares.

State Shares are shares held by state-owned units designated by the Government and may only be sold or transferred with the approval of the State asset administrative departments. *Legal Person Shares* are shares held by a company or legal entity which does not include the State or natural persons. Taken together, State Shares and Legal Person Shares account for something around nine times the number of shares listed on the Shanghai and Shenzhen Exchanges. Although there are stringent restrictions on the transfer of such shares, an "underground" market has developed and this has been sufficiently active to cause the State Council to issue a Notice in April 1993 to the effect that the State Commission for Restructuring the Economy, the Ministry of Foreign Trade and Economic Relations and the State Council Securities Committee will be cooperating to curb illegal trading. *Individual Shares* are shares held by the staff and workers of the company or shares held by individual public investors.

Collectively, these three types of shares are referred to as "A" shares and may be purchased only by Chinese nationals, although enterprising persons in Hong Kong and Taiwan have been known to purchase "A" shares.

By the end of 1991 there were about 3,300 PRC enterprises which had converted themselves into "limited liability joint-stock companies" having issued legal person shares or individual shares. By the end of 1992 this number had grown to about 4,000.

Foreign Investment Shares (Special RMB Shares) are shares held by governments, legal persons and individuals outside China and are used as a means of attracting direct foreign investment into both Chinese enterprises and joint ventures, as well as a mechanism for assisting the development of the securities markets. Special Shares issued and listed on the two Exchanges are called "B" shares which are denominated, traded and settled in US$ (initially they were denominated in RMB). Broadly speaking, owners of "B" shares enjoy the same rights and bear the same obligations as holders of "A" shares.

As at 31 March 1993 securities listed on the Shanghai Securities Exchange consisted of 37 bond issues (of which four were Treasury Bonds, 11 were Financial Bonds, and 22 were Enterprise Bonds), 43 "A" shares and 10 "B" shares.

Trading activity on the Shenzhen Stock Exchange is basically confined to stocks and as at the end of March 1993, there were 24 "A" shares, nine "B" shares, one warrant and five bond issues listed on the Exchange.

The Issue and Secondary Trading of Securities

Issue

In China, regulatory responsibility for securities issues is dispersed amongst a number of authorities. While the MOF is responsible for the issue of Treasury Bonds, the State Planning Commission approves the issue of Enterprise Bonds, and the responsibility for share and bond issues over RMB30 million lies with the PBOC. The newly formed CSRC and Provincial Regulatory Commissions also have approving responsibilities for listed equity issues.

An issue of "A" shares can be accomplished by way of a public offer, a private placement (in which case a transfer of shares can only occur between legal persons) or an internal issue (whereby shares are issued to the staff and workers of a company, provided that the issue does not exceed 30% of the total shares of the company). A public offering of "A" shares is made through the so-called "lottery" system whereby subscription forms in respect of selected potential issuers are made available to domestic investors whose applications "go into a barrel". The draw to determine the successful applicants is generally held in the format of a televised lottery.

An issue of "B" shares can be accomplished by way of either a public offering or a private placement. A public offering can only be conducted through an approved securities institution. If an issue is made through a distribution syndicate representing the issuer, it must be managed by an authorised PRC securities institution, which acts as the main distributor, together with approved foreign institutions. A private placement of "B" shares can be made to legal persons outside China with the prior approval of the appropriate regulatory authorities.

In order to issue and list securities in *Shanghai*, an issuer must apply to the Shanghai Securities Exchange and to the recently established Shanghai Securities Regulatory Commission, either directly or through a securities company or trust and investment company. The regulations require that a newly established joint-stock company must, amongst other things, obtain an asset valuation performed by a recognised asset valuation organisation, and that the organisers of the issue subscribe for not less than 30% of the total amount of shares to be offered. An existing joint-stock company which wants to issue shares to increase its capital must provide financial statements, certified by an accounting firm, reflecting continuous profits for at least the two preceding years and the preceding quarter of the current year.

There are additional regulations in respect of "B" shares, including requirements that the company has stable and adequate foreign currency income to fund dividend payments and that the proceeds of the issue must be used in accordance with State policies on the administration of foreign investment.

The regulations governing the issue of shares in *Shenzhen* are a little more stringent than those in Shanghai. A prospective issuer must apply directly to the Shenzhen Securities Regulatory Commission for approval - it must have net assets of at least RMB10 million; the ratio of net tangible assets to total assets must be not less than 25%; following any issue of shares, at least 25% of its shares must be held by the public and the company must also have a minimum of 800 shareholders. To issue "B" shares in Shenzhen, the issuer must also have a three-year operating record.

In *Shanghai*, bond offerings with a total value of RMB10 million or more must be open to public participation. In addition to certain required documentation, the issuer must submit financial statements of continuous profits for the two preceding years and the preceding quarter of the current year, certified by a registered accountant. The issuer must also apply to a credit-rating organisation designated by the PBOC for a rating of the bonds. Approval is only given to the issue if the bonds receive an A-rating or higher. There are no specific provisions governing the issue of bonds in Shenzhen since the market is relatively small at this stage. Although non-financial institutions have been made responsible for acting as underwriters, and specialised banks as agents, for issuing government bonds to individual investors, government bonds are still issued to institutional investors in a "compulsory manner" at lower interest rates and trading is prohibited.

The offer period for new issues varies as between regions. It must not exceed 90 days in Shanghai and 60 days in Shenzhen (the period commences with the date of approval and runs through to the conclusion of the distribution period). Securities remaining unsold after this period cannot be offered for sale again without the approval of PBOC.

Trading

Trading of stocks and bonds is conducted through OTC markets via the STAQ system as well on the two exchanges, whilst trading of listed shares takes place only on the two exchanges. By the end of 1992, there were approximately 70 specialised securities companies, 1,000 enterprises with securities operations, and 5,000 securities trading counters throughout China.

OTC trading takes place through securities agencies which match buying and selling orders. The markets are far from perfect and demand and supply differences between different OTC markets frequently result in disparate pricing in respect of the same security.

The STAQ facility currently links 43 cities and more than 70 licensed trading corporations via a satellite communication network and computer interfaces, with its centre located in Beijing. The functions of the system include dissemination of market information and price quotations for the various OTC markets, statistical analysis, scripless trading and clearing and settlement services. At the end of 1992, there were 10 bonds trading in the system and since July 1992, the system has also provided a pilot trading facility for Legal Person Shares. In March 1993 it was announced that 15 companies with a flotation value of RMB750 million were seeking quotations for Legal Person Shares on the STAQ system and that STAQ plans to approve one or two companies per month with each flotation worth about RMB30 million.

Trading on the Shanghai and Shenzhen Exchanges is carried out by means of a computerised, automatic matching system which executes each transaction based upon price and time priority. Trading information is displayed on an electronic screen in the trading hall and is transmitted electronically to members' trading terminals. "A" shares are quoted in RMB and "B" shares in US$. Only cash account trading is permitted. Margin trading, index trading and short selling are prohibited.

Trading of "B" shares must be conducted on the two exchanges through an authorised local broker or through an approved foreign broker. Overseas investors must have an account with the clearing house of the exchange and execute transactions through authorised foreign brokers, who in turn instruct authorised local brokers (recently Shanghai moved to give some foreign brokers direct access to "B" shares). Foreign securities houses wishing to become authorised foreign brokers must file applications with the PBOC, and if approved are required to enter into agency agreements with only one of the local brokers prior to their participating in any purchase and sale of "B" shares.

Settlement of On Market Transactions

Both exchanges have adopted central clearing systems to facilitate the clearing and settlement of "A" share transactions. In order to clear and settle bonds and "A" shares, each authorised broker must open an account with the PBOC and maintain a balance sufficient for settlement purposes. Clearing and settlement is done on a "net settlement" basis whereby a broker is only required to settle the net monetary balance after offsetting the amounts payable with the amounts receivable. For shares, the system is scripless, working on the basis of electronic book entry.

In respect of "B" shares, the clearing and settlement cycle must be completed on T+3. In *Shanghai*, all "B" shares are settled in US$ at a rate representing the weighted average exchange rate of US$/RMB at the Shanghai swap centre during the preceding week. As from April 1993 clearing and settlement functions are performed by the new Shanghai Central Securities Registration and Settlement Company, which will enhance the efficiency of the previous two-stage settlement process.

In *Shenzhen*, all "B" shares are settled in HK$ at a rate based on the preceding day's closing price of HK$/RMB at the Shenzhen swap centre (the settlement currency is expected to be US$ as from 1 June

1993). Clearing and settlement is handled by one of the three approved banks: Citibank, Standard Chartered Bank and Hongkong and Shanghai Bank.

In Shanghai, the administration of securities' listings, trading, clearing, settlement, custody and registration rests exclusively with the Shanghai Securities Exchange, whilst in Shenzhen, the registration of shares rests with the clearing agent of an issue, which maintains a list of shareholders of the issue and reports to the Shenzhen Registrars Company Ltd., the central registrar for securities in Shenzhen. At present, in Shenzhen, the appointment of a clearing and registration agent is issue specific, i.e. an issuing company can only appoint one of three approved banks as the central clearing and registration agent for its shares.

Membership of the Two Securities Exchanges

The two PRC Exchanges operate on a not-for-profit basis, adopting a membership system which permits institutions engaged in the securities business to access the trading market. Both Exchanges have a diversity of members including securities companies, trust and investment companies, insurance companies, banks, finance companies and credit co-operatives. Approvals must be obtained from both the CSRC and the PBOC before admission can be obtained. Members can conduct both agency and principal business.

Shanghai has admitted members from the local region as well as from other areas such as Beijing, Shandong, Shenyang, Anhui, Jiangxi, Zhejiang, and Hainan. In mid-1992 Shanghai had 81 approved members and 106 seats, but this was increased to 200 seats and more recently to 600 seats, all of which have been taken up. The Exchange is currently constructing a new building and it is understood that it is planning to accommodate 1,600 seats. Recently, Shanghai created a new class of membership (which falls short of full membership) by establishing new seats to be made available to foreign brokers (to be held in the name of a Shanghai broker nominee) to enable them to deal directly in "B" shares. As at the middle of May 1993, 23 foreign brokers had been admitted to this category of membership.

Shenzhen has a much smaller number of members, 85, of whom about half are from Shenzhen itself and the other half mainly from the neighbouring Guangdong Province. In view of the move by the Shanghai Securities Exchange to open its membership to foreign brokers, the Shenzhen Stock Exchange has recently put forward a proposal to allow foreign brokers "full membership" of its Exchange. This proposal is currently under study by the Shenzhen Securities Regulatory Commission.

The Equities Market in Shanghai and Shenzhen

In common with many other developing markets, the markets in both Shanghai and Shenzhen are highly speculative, exhibiting significant volatility, in terms of both price and volume. As at the end of February 1993, the two Exchanges had a combined market capitalisation of about RMB184 billion (Shanghai RMB119 billion and Shenzhen RMB65 billion). This is equivalent to US$32 billion and compares with US$198 billion in Hong Kong. Exchanges with a similar market capitalisation to Shanghai/Shenzhen are Santiago (US$34.8 billion), Copenhagen (US$34.6 billion) and Tel-Aviv (US$29.8 billion).

Because of the different characteristics of the shares, it is useful to consider the "A" and "B" share markets of Shanghai and Shenzhen separately.

The Markets for "A" Shares

"A" share listings on the two Exchanges obviously coincided with their openings in late 1990 and mid-1991 - by mid-1992 there were 14 "A" share listings in Shanghai and 17 in Shenzhen, and by 30 April 1993 there were 43 in Shanghai and 24 in Shenzhen.

Shanghai: The novelty of stock markets together with the availability of a substantial supply of savings in cash form created an overheated market throughout the first part of 1992 which saw the Shanghai share price index move rapidly upwards. However, upward movements were constrained by PBOC (Shanghai Branch) daily price fluctuation limits of 1% (they were tightened from 5% to 1% in July 1991) so that market efficiency problems emerged as demand clearly outstripped supply. In May 1992 the authorities focused on various measures to tackle these problems, including varying the price limits (they were eventually abolished), extending trading hours and banning trading syndicates. In response, prices rose by between 350 and 450% but after June the market went into decline for the rest of the year as more new issues were floated and investors became far more cautious. During the first six weeks of 1993 the "A" share market took off for a second time but since then prices have again gone into decline. Throughout 1993 excessive speculation has remained a significant problem and the Shanghai Exchange has responded by bringing in a rule to prohibit bids which exceed the current quoted price by more than 3%.

In similar vein to prices, volumes have also fluctuated considerably, for example, during February 1993, volume built up to significant levels - on 9 February the Shanghai "A" share market had a record turnover of RMB1.65 billion (equivalent to HK$1.56 billion on a day when the Hong Kong market experienced a turnover of HK$1.57 billion). Currently turnover is much quieter.

Shenzhen: Similar factors to those operating in Shanghai established a highly speculative bull market until May 1992. The index reached a peak on 27 May but then declined by about 25% in two weeks, remaining in a downward consolidation phase for the remainder of 1992. With one exception, Shenzhen has not set "price limits" to curb excessive speculation, but the Authorities have established a "fund" to smooth out price fluctuations by way of open market operations.

The image of the Shenzhen Exchange was tarnished to a considerable extent by the widely publicised share subscription form riots of August 1992 and by the events surrounding a company - Shenzhen

Champagne - which involved detention of some of the company's executives. Throughout 1993, Shenzhen has been working at rebuilding its image, but market volatility continues.

There is no doubt that at this stage, the "A" share market is still very much in the experimental phase with trading by speculators dominating market activity. Price-earnings ratios (P/Es) are at very demanding levels (estimates indicate an average of about 120 times in Shenzhen and 135 times in Shanghai) and the evidence points to buyers holding stocks for short periods only. Official concerns have been expressed about these matters and it seems likely that continuing efforts will be made to dampen down the speculative elements (in March 1993 regulations were released to limit speculators from cornering the markets).

The Markets for "B" Shares

"B" shares first emerged on the two Exchanges in early 1992 - as at 30 June 1992 there was one "B" share issue listed in Shanghai and seven in Shenzhen, and by the end of 1992 each Exchange had nine "B" share listings, the initial offerings for which raised US$640 million in Shanghai and US$170 million in Shenzhen. Currently there are 10 "B" shares listed in Shanghai and nine in Shenzhen and it is expected that by the end of 1993 total listings of "B" shares might have grown to between 30 and 40 companies.

Shenzhen: The initial launch of the seven "B" share listings in Shenzhen coincided with intense interest by some fund managers in Hong Kong which pushed up prices quickly on strong turnover. P/E ratios for the initial public offerings averaged 8.5 times, but increased rapidly to a peak in mid-May as newly launched funds built up their portfolios. However, from early June 1992 the market went into a state of almost continuous decline as prices retreated and turnover stagnated with liquidity becoming a major problem. The correction was a normal reaction to an overheated market, but was also associated with the launch of large tranches of "B" shares in Shanghai and the decline in investor confidence as a result of the share subscription form incidents in August. Despite this, at year end 1992 all "B" shares listed on the Shenzhen Exchange finished at significant premiums to their issue prices, although well off their year highs.

Sentiment recovered in early 1993 and Shenzhen "B" share prices again rose rapidly. There was a 49% surge in prices over six trading days from 1 February to 8 February (largely associated with rumours that "B" share quotations were to be changed from RMB to HK$) and valuations became unsustainable with P/Es in excess of 30 times. Under these circumstances prices began to decline and have remained subdued since then. Liquidity has also been a problem and it is not unusual to find days on which only about half the "B" shares trade.

Shanghai: The launch of "B" shares in Shanghai took place in the second half of 1992 with significantly larger offerings and at significantly higher P/Es than had occurred in Shenzhen during the first half of the year. The Shanghai listings raised four times the amount of capital on P/Es of about 18 times 1992 earnings. These demanding requirements, together with the factors mentioned earlier, placed considerable pressure on the Shanghai "B" share market with the result that, by year end, with one exception, all the stocks finished at large discounts to the issue price.

As has been the case in Shenzhen, Shanghai "B" shares have also been volatile throughout 1993. Intra week volatility has been substantial, for example, prices rose by 7.9% and 9.2% on 14 and 15 February (due to Lunar New Year Bulls) whereas they fell by 7.4% on 3 February, following news that the Shanghai Foreign Exchange Administrative Bureau was to crack down on "local" buying of "B" shares which had become more open.

Some "B" share problems: There is no doubt that international investors continue to remain wary of "B" share stocks despite the strong rate of economic growth which is expected to take place in China for any medium term forecast period. Investors remain cautious because of such factors as continuing depreciation of the RMB, the embryonic state of companies and securities regulation, failure of companies to publish results in accordance with International

Accounting Standards, failure of management to publish results in a timely manner and via a medium convenient for international investors, concerns about selective release of shareholder information, concerns about the methodology of rights issues, and concerns about "quality of earnings" in that China companies seem to be interested in "investment speculation" rather than building core-business strengths.

China Funds

The emergence of China "B" shares for listing and trading in Shanghai and Shenzhen was rapidly followed by the launch of "China funds", the first of which appeared within a month of the listing of the first two "B" shares in February 1992.

Between March and August 1992, over 20 China funds, both open and closed-end, were launched in the face of wide institutional and retail investor interest in the development of China's securities markets. Most of these funds were closed-end vehicles, listed in Hong Kong, London or New York, raising some US$1 billion for investment in "B" shares, unlisted Chinese issues and China concept stocks listed in Hong Kong. A number of these funds have been structured to become open-ended within two years.

In addition to the closed-end funds, some US$200 million was raised in the initial launches of nine open-ended "B" share funds. These funds were all authorised in Hong Kong, many of them being sub-funds of existing umbrella funds already authorised in Hong Kong and domiciled in Luxembourg, the Channel Islands or Bermuda.

The open-ended funds were authorised by the Securities and Futures Commission (SFC) on the basis of full compliance with existing regulations, including liquidity and diversification requirements, and stringent risk disclosure. The focus of the risk disclosure was on PRC market capitalisation and liquidity, the then undeveloped nature of the legal, regulatory and accounting framework in the PRC, and the more general political risk associated with the PRC's experiment with market mechanisms.

Despite these risk warnings, the enormous demand for "B" shares unleashed by these funds led the SFC to issue an additional risk warning concerning the effect on price volatility of the significant imbalance between supply and demand. And during the early days of the China fund boom, when there were almost as many China funds as there were listed "B" shares, the SFC closely monitored advertising to ensure that funds did not promise more exposure to the "B" share market than was in fact possible.

At present, activity is much quieter on the China fund front. Although some of the open-ended funds are fully invested in "B" shares, most are invested (to varying degrees) in Hong Kong-listed China concept stocks.

Regulation of the Equities Markets

At present, regulation of the PRC equities markets is still very much in the development stage - the new national Securities Commission is still in start-up mode (as are the Provincial Regulators in Shanghai and Shenzhen), demarcation lines between Authorities have not yet been clarified, national laws and regulations are still in the process of being drafted, and there are some uncertainties concerning the framework within which existing regulations have been established.

Regulatory Authorities

Pursuant to a resolution on 12 October 1992 the State Council of China established the CSRC, under the Chairmanship of Professor LIU Hongru, to regulate China's securities markets. The SFC's link to the State Council is via SCSPC chaired by Vice Premier ZHU Rongji. The SCSPC is the macro policy-making body and consists of representatives from Government organisations who have an interest in securities regulation, for example the PBOC and the MOF.

The CSRC shares regulatory responsibilities in respect to the securities industry with other agencies, including the PBOC (which has responsibilities for matters such as approving licences for intermediaries, approving mutual fund managers, and approving issues of mutual funds) and the Provincial Regulatory Commissions.

At the regional level in Shanghai and Shenzhen, municipal Regulatory Authorities (the Shenzhen Securities Regulatory Commission and the Shanghai Securities Regulatory Commission) have recently been established to perform supervisory tasks, especially in relation to Provincial issuers and intermediaries. In Shenzhen, a two-tiered regulatory structure has been established along similar lines to the Beijing model. The Shenzhen Securities Regulatory Commission commenced operations on 1 April 1993 comprising officials from the local PBOC and the Municipal Economic Systems Reform Committee whose functions are to deal with day-to-day operational issues such as supervision of new issues, listing, trading and supervision of intermediaries and professionals. The Shanghai Municipal Securities Regulatory Commission started operations in March 1993 with a brief to regulate the market in Shanghai.

Finally, the Exchanges in Shanghai and Shenzhen undertake the normal functions performed by most other stock exchanges, such as approving securities for listing and regulating the activities of members.

Securities Regulatory Requirements

National level laws (and regulations) are still being developed, a dynamic process which will evolve over a period of years. The main regulatory requirements are being framed in the following documents:

(i) The Provisional Regulations of the State Council on the Administration of Securities. These Regulations, when promulgated, will provide for the establishment of the SCSPC and the CSRC and define their respective responsibilities and powers. Other matters include basic requirements and obligations for securities intermediaries and issuers, and requirements concerning trading of securities, management of investment funds and clearing and settlement. It also sets out investigation powers for the CSRC as well as the penalties which might be imposed on those who violate the regulations.

(ii) The Standard Opinion on joint-stock companies - a document issued by the State Commission for Restructuring the Economic System and which establishes a basic framework of shareholders' rights and corporate governance (it contains some of the types of requirements normally set out in western company law).

(iii) Provisional Provisions on the Registration of joint-stock companies - to be promulgated by the State Administration of Industries and Commerce (SAIC), and which sets out the requirements for a joint-stock company to be registered as a legal person. The SAIC issues Certificates of registration, evidence that a company has legal status.

(iv) Provisional Regulations on the Administration of Stock Issuance and Trading. These are requirements issued on 22 April 1993 which currently constitute the national law governing the issuance and trading of "A" shares within the PRC, although this is not the national securities law. The measures contain detailed provisions relating to the issue of shares (prospectus requirements, etc.), trading of shares (listing requirements, etc.), takeovers of listed companies (including requirements to make tender offers once a 30% threshold is reached), the disclosure obligations of listed companies, and offence provisions for market manipulation, etc.

(v) The Company Law of the People's Republic of China - this is being drafted by the law drafters of the Standing Committee of the National People's Congress and will eventually establish company law in China on a firm footing (it will supersede regulatory requirements (ii) and (iii) above).

(vi) The Securities Law of the People's Republic of China - being drafted by the law drafters of the Standing Committee of the National People's Congress - and which will eventually absorb the share issuance and trading requirements mentioned above. The draft securities law sets out provisions concerning powers of the new national regulatory bodies, the issuance of securities (including qualifications of issuers and documentary requirements), disclosure of important events (news dissemination), securities trading, disclosure of interests, insider dealing and other market malpractices, the licensing of securities intermediaries, takeovers and mergers, investment funds, securities exchanges and OTC markets, and a mechanism for the arbitration of disputes and penalties for contravention of such provisions.

Because trading of equities in Shanghai and Shenzhen has preceded the implementation of national companies and securities laws, various regulatory requirements have had to be developed at the regional level. For example, the Shanghai PBOC, the Shanghai Municipal People's Government and the Shanghai Branch of the State Administration of Foreign Exchange Control have promulgated requirements such as:

- Operating Rules for the Trading Market of the Shanghai Securities Exchange (1 December 1990);
- Procedures on the Administration of "B" shares (22 November 1991);
- Implementing Rules for the Administration of "B" shares (25 November 1991); and
- Provisional Regulations Relating to Companies Limited by Shares (18 May 1992).

Similar requirements have been introduced in Shenzhen to underpin the development of its market.

Listing of China Enterprises in Hong Kong

For some years now, Hong Kong has been the focal point for listing what have become known as "China concept" stocks - i.e. companies incorporated in Hong Kong, Bermuda or some other English common law jurisdiction but whose assets are predominantly (if not all) located in China. Notable among the China concept stocks are companies such as China Travel Service, Guangdong Investment, Guangzhou Investment, China Oversea Land & Investment and Denway Investment which were incorporated and listed on the Stock Exchange of Hong Kong (SEHK) under control of PRC interests.

The China concept stocks have obviously added a further dimension to the Hong Kong market, but in some respects, and more importantly, they have provided the basis for an evolutionary move to list, on a primary listing basis, PRC-incorporated enterprises in Hong Kong. This market development initiative, which has been in progress for about 12 months, involves major path-breaking work for both the SEHK and the SFC in terms of devising an appropriate *investor protection framework* and *efficient market structures* to enable the listings to proceed.

Investor Protection Framework

The underlying philosophy of the current SEHK listing rules is that an overseas issuer seeking a listing on the Exchange must be established in a jurisdiction where the standards of shareholder protection are at least "equivalent" to those provided in Hong Kong. Given the particular nature and stage of development of the PRC securities markets, the legal and accounting systems, the regulatory structures and the business and governmental framework, it became clear that the concept of "equivalence" could not apply. As a substitute, the various regulatory authorities have developed the concept that there should be a "sufficient" level of shareholder protection.

In order to establish a "sufficient level" of shareholder protection, the important issues which have been addressed include:

- Developing a package of "shareholder corporate rights" (Package 1).
- Developing a package of "shareholder securities market rights" (Package 2).
- Developing procedures to ensure that the investor protection requirements work in an operational sense (Package 3).

Package 1 "Shareholder Corporate Rights" - PRC state-owned enterprises which intend to apply for listing in Hong Kong will be converted into joint-stock companies. They may issue two types of shares which will rank pari passu: one type denominated in RMB, listed and traded only on PRC exchanges and available only to Chinese citizens and domestic entities (the "A" shares), and a second type, also denominated in RMB, but listed and traded in Hong Kong dollars on the SEHK and available only to overseas investors (the "H" shares). The "H" shares are not the same as "B" shares (which are US$-denominated shares listed and also available only to overseas investors) in that "B" shares are traded on a Chinese exchange and do not provide the corporate and securities market investor protection aspects which are a feature of the package discussed below. It is envisaged that enterprises with "H" shares will not issue or list "B" shares on any PRC exchanges but that they will most likely have concurrent offerings of "A" shares in China and "H" shares in Hong Kong.

The basic building block of Package 1 is the "Standard Opinion" promulgated by the PRC State Commission for Restructuring the Economic System and which sets out the rules for establishing a joint-stock company. Because the Opinion does not coincide with Hong Kong company law (there are gaps, overlaps and conflicts) it has been necessary to develop mechanisms to "reconcile" the Opinion with Hong Kong company law with regard to corporate governance matters. This has been done by a combination of methods, including:

- A mandatory standard set of Articles of Association which enshrines into the Articles of the PRC State Enterprise and establishes as a matter of contract many rights which are contained in Hong Kong corporate law, but which are not contained in the Standard Opinion. For example, they contain such matters as rights of shareholders, directors' fiduciary duties, the rights of one class of shareholders *vis-à-vis* another, financial disclosure matters and an arbitration mechanism for resolving disputes in relation to the affairs of the company. Of particular importance is the provision which gives each shareholder a direct cause of action against any director who is in breach of his duties as a director where normally it would be the company rather than the shareholder who will have the right of action. There are also provisions which, with one exception, require the passing of a special resolution by a specific class of shareholders before the rights of that class can be changed.
- An "Addendum" and an "Explanatory Note" to the Standard Opinion which, for those PRC state enterprises wishing to list in Hong Kong, bring the Standard Opinion into line with Hong Kong practice and provides authoritative interpretation of the Standard Opinion.

Package 2 "Shareholder Securities Market Rights" - PRC state-owned enterprises offering the "H" shares will be required to comply with the prospectus requirements of the Hong Kong Companies Ordinance and with the listing requirements of the SEHK, and once listed on the SEHK, a PRC issuer will be subject to all relevant laws and non-statutory requirements in Hong Kong, such as the Securities Ordinance, the Securities (Insider Dealing) Ordinance, the Securities (Disclosure of Interests) Ordinance, the Companies Ordinance insofar as it is applicable to a Part XI overseas company, the Protection of

Investors Ordinance and the Codes on Takeovers and Mergers and Share Repurchases.

As would be expected, it has been necessary to make some amendments to the *SEHK Listing Rules*, in particular there are modifications to the Listing Agreement and the enterprises' memorandum and articles of association, which are specified in a new section in the Listing Rules in a similar manner to that provided for companies incorporated in Bermuda and the Cayman Islands (approximately 50% of all companies currently listed on the SEHK are incorporated in Bermuda and the Cayman Islands). Specific amendments to the Listing Rules include a requirement that a PRC issuer retain for a minimum period of three years, a sponsor or an acceptable professional firm in Hong Kong to advise it on compliance with the Listing Rules, a requirement to have two independent non-executive directors, a requirement that the public float of "A" plus "H" shares represents at least 25% of the company's share capital (and that "H" shares represent the higher of HK$50 million or 10% of the company's share capital, and that all "H" shares must be held by the public).

A particularly important component of Package 2 relates to the *Accounting Standards* to be used for reporting purposes. The current provisions of the Listing Rules require all companies listed on the SEHK, including overseas companies, to comply with accounting standards approved by the Hong Kong Society of Accountants (HKSA) and laid down in the Statements of Standard Accounting Practice issued periodically by the HKSA, or with International Accounting Standards (IAS), as promulgated periodically by the International Accounting Standards Committee.

In the PRC, state-owned enterprises are currently required to comply with the accounting standards promulgated by the MOF in respect of their particular category. On conversion to joint-stock enterprises they will be required to comply with the "Joint-Stock Company Enterprises Accounting Standards" promulgated by the MOF in 1992. These contain a number of significant departures from IAS, for example, in such areas as accounting for foreign exchange transactions, depreciation, costs of maintaining plant and machinery and date of commissioning. As these departures could cause significant problems in terms of interpreting reported profits and financial position (with implications for dividend distribution, etc.) it has been necessary to establish a framework which will satisfy both PRC and international investors.

The approach which has now been agreed involves PRC enterprises listed in Hong Kong presenting two sets of accounts - one certified to be in compliance with the PRC Joint-Stock Enterprise Standards and the other certified as "true and fair" in accordance with IAS, normally by an "international" auditing firm. Audits must be conducted in accordance with International Auditing Standards. IAS will be used for initial and on-going disclosure purposes under the Hong Kong Listing Rules and the Hong Kong Takeovers Code. The maximum amount of distributable profit for the corporation will be based on the lower of the profit established by PRC Accounting Standards and IAS.

The other important element of the "securities markets rights" package concerns *disclosure*. Like any other issuer in Hong Kong, a PRC issuer will be subject to the disclosure requirements of the Companies Ordinance and the Listing Rules, including disclosure of certain special factors in the prospectus. The special factors will include a summary of:

- the relevant PRC laws and regulations;
- the political and economic environment/structure of the PRC;
- the foreign exchange control and the exchange rate risk of RMB;
- the untested nature of the regulatory framework being developed for the PRC listing;
- specific risk factors related to the business of the issuer or its products; and
- investor protection mechanisms which are different from that generally available in Hong Kong.

Package 3 "Procedures" - In order to ensure that the investor protection requirements set out in the two packages mentioned above work in an operational sense, we have developed two important sets of procedures.

First, we have prepared a *Memorandum of Regulatory Co-operation* (MORC) between the SFC, the SEHK, the CSRC and the two China Exchanges which establishes a framework for mutual cooperation in regulatory matters and sets out the issues and principles to be taken into account in coordinating regulatory efforts. The basic principles underlying the MORC are the protection of investors, the maintenance of fair, orderly and efficient markets, and ensuring compliance with each other's laws and rules. The scope of the MORC therefore covers not only PRC enterprises listed in Hong Kong, but also issuers of securities, directors, officers, shareholders and professional advisers of all companies listed in the PRC or Hong Kong; dealers and investment advisers operating in the PRC or Hong Kong; trading, clearing and settlement activities; insider dealing, market manipulation and other fraudulent practices on any stock market in the PRC or Hong Kong; as well as training and exchange of personnel and other markets agreed by the parties. Specific areas of cooperation, and detailed mechanisms for that purpose, cover company news dissemination, suspension of trading, takeovers and mergers, regulation of intermediaries and standardisation of securities terms. The list may be revised as and when the need arises.

Like other Memoranda of Understanding entered into by the SFC, the MORC contains a statement of intent which does not impose legally binding obligations on the signatories. As such, it has no power to override domestic laws and regulations, nor does it affect other channels of cooperation.

Second, a mechanism has been established to facilitate the resolution of disputes. It has been agreed that disputes concerning the affairs of the company involving Hong Kong or international "H" shareholders and other parties will be resolved by arbitration in accordance with the law of the enterprises' jurisdiction of incorporation (i.e. PRC law, which will include the Standard Opinion and the Addendum). Arbitration may take place either at the China International Economic and Trade Arbitration Centre (CIETAC) or the Hong Kong International Arbitration Centre (HKIAC), at the election of the claimant. Hong Kong has nominated six members to the panel of CIETAC while the PRC has nominated six members to the panel of HKIAC. Arbitral awards by CIETAC and HKIAC, both of which are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, will be enforceable in both jurisdictions.

The arbitration provisions do not apply to such matters as claims arising from investor protection laws regulating the marketing, sale, purchase, trading or other activities in the securities of the company. Hong Kong courts will have jurisdiction over all such claims.

Efficient Market Structures

As I have mentioned previously, trading of the "A" shares will take place on PRC Exchanges and trading in the "H" shares will take place in Hong Kong, and possibly elsewhere. Because of the foreign exchange constraints, the two sets of markets will be influenced by somewhat different demand and supply conditions, so that prices are likely to diverge (just as they do at present for "A" and "B" shares). There do not appear to be any special problems from a trading point of view, although a number of issues relating to dividend payments and registration have had to be considered.

Trading of "H" shares on the SEHK will be conducted using the same facilities and will be subject to the same trading rules that apply to all other SEHK listed companies. Clearance and settlement of "H" shares will be effected through Hong Kong's central clearing system (CCASS) on a fully netted and guaranteed basis.

Dividend payments for holders of "H" shares will be based on the exchange rate quoted by the Shenzhen Foreign Exchange Adjustment Centre. Any loss of dividend value due to the conversion of RMB to Hong Kong dollars will be made up by the company, so that the holders of "H" shares will be paid the same amount of dividend as the "A" shareholders.

A register of shareholders will be maintained in Shanghai or Shenzhen for "A" shareholders and another register will be kept in Hong Kong for all holders of "H" shares. The Hong Kong registrar will provide, on a monthly basis, a copy of the register of shareholders to the registrar in China, to enable the company to have up-to-date knowledge of both its "A" and "H" shareholders. The Hong Kong Securities Clearing Company has set up a company to act as the Hong Kong registrar for the China issues to be listed on the SEHK. The registration process for "H" shares will be the same as any other shares in Hong Kong, except that at the time registration is requested, the transferee will have to agree in writing to submit to arbitration in order to pursue an action against the company or a director as required by the mandatory provision. This process will be accomplished via the insertion of a statement into the document required to be signed by the transferee and issued to the registrar in order for shares to be transferred into his or its name.

Closing Remarks

The experiments currently underway in developing securities markets in China have met with initial successes, although, as we have mentioned throughout this paper, there are a considerable number of issues still to be addressed over time. Many of the issues will probably be resolved by trial and error as various participants in the market - the regulators, the exchanges, the intermediaries, the issuers and the investors - develop more experience. There is little doubt that in some instances the learning process will be painful - history tell us that all securities markets in the world have undergone such processes. Having said this, there is also little doubt that, given the size of China's economy (according to recent IMF statistics, it is now the third largest in the world) and China's high propensity to save, there is enormous potential for the growth of its securities markets. If China's current economic policies continue, it is not beyond the realms of possibilities that by the year 2000 its equities markets will rank in the top 15 in the world.

ROBERT NOTTLE

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

8

Article for "Capital Asia"
2 September 1993

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.

PART V

HONG KONG AFTER 1997

Anthony Neoh became the third Chairman of the Securities and Futures Commission in 1995 till 1998. It was an eventful period that saw Hong Kong's return to China, the Barings debacle and the Asian Crisis. Hong Kong's capital markets continued to grow and remained resilient and robust.

In his inaugural speech, Anthony Neoh shared his thoughts on the future of Hong Kong continuing as an international financial centre as enshrined in the Basic Law, and in helping China raise capital to finance its massive investments. The second speech provided his perspective of the shape of things to come in the aftermath of the collapse of Barings. In the third speech, Anthony Neoh examined the eight features of successful markets and the eight decisions that need to be made in constructing a securities law. The fourth speech pointed to the importance of investor education.

This chapter also contains a speech each by Michael Wu, then Deputy Chairman of the Commission, Laura Cha and Mark Dickens, then Executive Directors of Corporate Finance and Enforcement respectively. Michael Wu pointed out the importance of having clear objectives of regulation, and the need for the regulatory approach in regional markets to be adapted according to the stage of market and institutional development. Laura Cha, in her speech, explained the role of the Commission in regulating listed companies, while Mark Dickens addressed the challenges of enforcement in a rising market.

Included also are two speeches by Edgar Cheng, then Chairman of the Stock Exchange of Hong Kong, on investor protection in Hong Kong and the debate on whether Hong Kong needs a Second Board.

Anthony Neoh

The Financial Markets of Hong Kong: Opportunities and Challenges of the Future

9

Hong Kong Investment Funds Association
Members' Luncheon
21 February 1995

Being new to the position of Chairman of the Securities and Futures Commission, I believe that probably the most useful thoughts that I can express, at this stage of my learning curve, are a few thoughts of the future. It was, after all, thoughts of the future that prompted me to accept this appointment.

When one speaks of the future, there must be some point in the past that we anchor upon as a landmark to compare both where and how far, we might go in the future. If I were to choose such a landmark, I would certainly choose the signing of the Sino-British Joint Declaration in 1985 and the market crash of 1987. The first event enabled hopes for the future to be built. The second, was a rude shock to Hong Kong's securities and futures markets and which resulted in many people losing a great deal of money, in some cases their life savings. But this event gave Hong Kong the impetus to build sound institutions for the future.

The Sino-British Joint Declaration created certainty, whereas until, 1985, there had been uncertainty. The Joint Declaration is, of course, important from a historical perspective but when one sees the great strides made in the reform of China's economy, and the continuing integration of Hong Kong's economy into that of China, there can be no doubt that the resumption of sovereignty by China over Hong Kong promises exciting possibilities for the future.

Let us look at the economic facts.

In 1993, the total value of visible trade between Hong Kong and China amounted to $740 billion. China is the largest market for, as well as the largest supplier of, Hong Kong's re-exports. Hong Kong has always been and will continue to be, an important gateway to China. In 1993, 23 million trips were made by Hong Kong residents to China. To this, should be added 1.9 million trips by foreigners. With the completion of the new airport, this traffic is expected to increase. Hong Kong accounts for two-thirds of all direct external investments in China. This is increasing with the establishment of investment funds both privately and through publicly listed vehicles. Fifteen Chinese State enterprises have so far listed in Hong Kong raising a total of $19 billion. Concurrently, China is investing heavily in Hong Kong and its banking links in Hong Kong are fast rivalling the largest international banking groups operating in Hong Kong. These statistics, coming nine years after the Joint Declaration, can only serve to prove the continuing economic inter-dependence between the Mainland and Hong Kong.

It will not be lost on those assembled here today that prices of Hong Kong securities are affected by the economic fundamentals both within Hong Kong's borders and within the borders of the Mainland. Some would no doubt feel that the winds of politics have also a part to play in this process. I would not venture to give investment advice to anyone nor do I feel that it is properly the role of a regulator to do so. However, as professionals in investment, you no doubt have a practiced eye to discern "truth from facts" and to judge the true emerging trends. I would suggest a few, from personal experience and from published sources.

In 10 years of teaching law and advising on new legislation in China, I have personally seen much encouraging change. When I started lecturing to Chinese lawyers at Shenzhen University in 1985, there were fewer than 10,000 lawyers in China. Today, the figure is now close to 100,000. Then, the first law school that resumed after the Cultural Revolution, Beijing University Law School, was about to graduate its third class of graduates. Now, every province has a law school, some with more than one. Then, China was beginning to send trainees abroad to study law. Today, law graduates return in droves to China. In every major city, you will find law firms with returned law graduates specialising in commercial legal work involving foreign parties. There is now a definite movement towards self-regulation of the legal profession.

When I first started to read Chinese law, there was only a "thin" ten-volume set of published legislation. Now Chinese legislation fills a shelf and to be manageable, needs to be stored in digital form. The computer database provided by the National People's Congress to the Securities and Futures Commission fills about 60 megabytes of space in a personal computer. It is updated quarterly, each time, in multiple disks.

In 1985, there were few legally qualified judges in the Chinese courts; now the preponderant number of judges in the Economic Chambers of Intermediate Courts (the level of court that deals with economic disputes of any significance and with foreign parties involving any amount) have university level legal qualifications, obtained in the past ten years. All judges are required to attend continuing legal education. International arbitrations in China have increased tenfold since 1985. The China International Economic and Trade Arbitration Centre (CIETAC) now has many well-known international arbitrators on its panel and since 1987, China has accorded to the Convention for Recognition and Enforcement of International Arbitrations Awards.

The International Monetary Fund, in a recently published occasional paper entitled "Economic Reform in China: A New Phase", produced a very handy summary of the structural reforms that have taken place or are about to take place. A thread that links all of these reforms is the acknowledgement for the need for greater transparency in Government. Rules and regulations, previously unpublished, have been rewritten and published, important examples of which, were foreign exchange rules, and foreign trade and tax regulations. Important infrastructural reforms have been the enactment of the Company Law, establishment of the central banking system, soon to be put on a statutory basis, the establishment of the China Securities Regulatory

Commission, the establishment of a National Tax Service which will collect revenue on the basis of a tax law (previously taxes were collected by local Governments who remit contracted amount to the Central Government), and steps taken in the privatisation of state-owned enterprises.

For someone who is supposed to speak for Hong Kong, I seem to be spending an inordinate amount of time on China. I have done this firstly, because the border that separates Hong Kong with the Mainland does not really exist in an economic sense. It has been suggested that Hong Kong is in a uniquely advantageous position of being a developed market in an emergent economy. Secondly, I do so to demonstrate that the legal and structural reforms in China are part of the institutional building which was a necessary part of the economic development that has taken place. As economic development continues, China will build more institutions. Thirdly, as you can see, China has not sought to "reinvent the wheel" with the institutions so far in place. Many of these institutions are already in place in developed economies. There is therefore a sound basis, as China builds its institutions into the 21st century, for common dialogue and understanding with the international community. Herein lies, in my view, the key to Hong Kong's success in the future.

The continuing acknowledgement on the part of China's leaders for the need to build lasting institutions is the best assurance that the institutions already enshrined in the Basic Law of Hong Kong will be respected. Hong Kong has stood, and will continue to stand, as a shining example as to how transparent legal and regulatory systems, consistently and fairly administered, can maintain a thriving economy.

As many of you know, the Basic Law ensures that the present legal and judicial system will continue into 1997 and beyond (except in the case of the right of final appeal, which in future will be reserved to the Special Administration Region (SAR), the present right of final appeal being to the Queen in Council). The SAR is given specific responsibility to ensure that Hong Kong continues to be an international financial centre:

Article 109 states that: *"The Government of the Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre".*

Article 110 states that: *"The Government of the Hong Kong Special Administration Region shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law".*

Article 112 states that: *"No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures and the like shall continue. The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region."*

While the Basic Law preserves, and in some cases extends our present institutions, the reforms in the securities and the futures markets instituted from the aftermath of the 1987 market crash now form the building blocks of the future.

In 1989, the Securities and Futures Commission was formed by statute. I have the great privilege to have been appointed the third Chairman of this organisation. Hong Kong has much to owe to the first two Chairmen, Mr Robert Owen and Mr Robert Nottle.

In the past five years, we have seen the establishment of many important landmarks in our market institutions. To start with, the Stock Exchange was fundamentally re-structured with a professional staff and a Council made up of members of large, middle and small sizes of brokerage as well as lay members representative of market users and professionals. The rules for listing have been radically revised to enable Hong Kong to set on the one hand, a level of shareholder protection as well as a level of market conduct expected of an international market and on the other, to enable companies incorporated in other jurisdictions (principally Bermuda and the People's Republic of China) to list in Hong Kong and thus, use Hong Kong as a place for capital formation. In the secondary market, state-of-the-art clearing houses and risk management systems have been put in place in both the Stock and Futures Exchanges. The Hong Kong Stock Exchange has established an electronic order driven trading system which automatically matches orders of up to 200 board lots. This system has a capacity of up to 300,000 transactions a day. At the height of the market in January 1994, when the index was touching the 13,000 mark, the highest daily trading volume exceeded $17 billion with the system easily handling over 110,000 transactions a day. The risk management systems in place have enabled Hong Kong's markets to withstand the volatility seen in the last few months. New financial products, particularly, financial derivatives, have come onto the market. This year, the Futures Exchange will be launching stock futures and currency contracts and the Stock Exchange will be launching traded options. This is a market which is constantly changing, thus constantly testing the skills and resourcefulness of our intermediaries and regulators.

The pace of change is, as always, dictated by the economic conditions of the region and, of course, of the world at large. Financial markets operate without regard to frontiers and herein, perhaps, lies the ultimate challenge of the future. Let us now look at the regional position as regards the need for capital.

The Asian Development Bank has estimated that at Asia's current level of physical infrastructure and assuming the current rate of GDP growth of 5% per year, some US$130 billion will be required annually. By the year 2000, some US$1 trillion (in 1993 money terms or US$1.2 trillion in money of the day terms factoring in inflation) will be required. And this is only for physical infrastructure. Add to this the thirst for housing and for social spending in the region. Fixed investment in housing has been estimated in an advanced economy as the United

States as 3% to 4% of GDP. In faster growing economies, the rate is almost certainly going to be higher. There is thus easily another US$1.2 trillion by the year 2000 needed for housing. Add to this too, the thirst for social spending for countries with ebullient economies and high aspirations. All this could add up realistically to some US$3 trillion of capital which is waiting to be raised by the year 2000. In this area, China's Government has in fact only set modest goals: the Chinese Finance Minister, in a recent speech in Hong Kong, announced that China intended to tap the international capital markets for US$500 billion in the next decade. As China probably figures for one third of the need for capital in the region, I would venture to suggest that the Finance Minister, true to the teachings of the ancient philosophers, and thus, a paragon of caution and master of understatement, has come in, at 50% under the mark!

Add to this equation too, the rate of savings in the Asian economies. Gross domestic savings in Asia has averaged 23% of GDP, with the faster growing economies attaining over 30% (Singapore 42.5%, China 34.4% and Hong Kong 31%). This means that the thirst for capital can in good part be quenched domestically if there are systems of intermediation which can enjoy public confidence. The thirst for capital and the corresponding willingness to quench this thirst has resulted in the fast growth of the securities markets of the region. Equally, the very high volatility of the regional securities markets have pointed to problems of liquidity and confidence, and generally of the need for adequate market regulation.

Add also to this equation, the potentially liberating force of the General Agreement on Trade and Tariffs (GATT) and the accompanying General Agreement on Trade in Services (GATS). The general principles of Most Favoured Nation status to all contracting parties and the consequent falling away of trade barriers and the requirement for transparency in domestic laws and their administration will liberate emerging economies by making increasing demands on their Governments for transparency of their rules and regulations and consistency in their enforcement which will serve to enable both their constituents and their foreign partners to find greater confidence. I see China joining as a retrospective founding member of the WTO in the not too distant future. The application of the principles of the GATT and the GATS in China will act as a fillip to the transformation which we are already seeing there.

Coming to the local scene, the increasing sophistication of the financial markets will continue to test the skills of our intermediaries. There are now many choices in the market and these choices are increasing as the market develops. The need for timely information and good research is greater than ever before. It is therefore no coincidence that more investors are turning to fund managers. Since 1987, when the number of authorised funds stood at 504, there are now 978. In 1978, there were only 46 authorised funds. From some 30 approved fund management companies in 1987, these are now over 100, including subsidiaries and affiliates of many of the world's major financial institutions.

The increase in the number of fund management companies is recognition by some of the largest institutions of what Hong Kong has to offer in terms of its legal and regulatory system, its infrastructure, its workforce, its proximity to China, and the sheer volume of funds requiring management. Hong Kong's monetary and fiscal reserves amount to over HK$300 billion. On 1 July 1997, in addition to accretion to the present reserves, there will be added the entire SAR Land Fund which presently stands at HK$60 billion. It is estimated that the SAR Land Fund will stand at, at least HK$100 billion on 1 July 1997. Add to this the many public and private pension or provident funds requiring professional fund management. The implementation of the Occupational Retirement Schemes Ordinance will make professional fund management even more important. Compulsory private retirement schemes, if they do come, will add another important source of work for fund managers.

It is my duty as Chairman of the Securities and Futures Commission to facilitate the development of the local markets so that they play their full part in the process of investment. In the coming months I hope to speak to as wide a circle of people both in and out of the industry to see what policies I should recommend to the Commission. I hope you will give freely of your advice to me.

ANTHONY NEOH

Life after Barings - the Shape of Things to Come

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Hong Kong Association of Banks - Annual Dinner
27 July 1995

I am honoured to have been invited to speak this evening, particularly, when I am sharing the occasion with my friend, Andrew Large, Chairman of the UK Securities and Investments Board. Andrew has been one of the principal moving forces in promoting the international effort to improve the regulation of securities and futures activities following Barings and the co-promoter of the Windsor Declaration.

The Barings Report prepared by the Board of Banking Supervision of the Bank of England makes fascinating reading. Like many of my colleagues who have read the Report, I was struck by the graphic description of the fundamental breakdown of internal controls in an outwardly sound and venerable organisation, particularly so, when Barings had experienced credit and risk managers as well as the relevant management committees. The case represents a salutary lesson to us all. The age-old caveat that no organisation can merely rely on structure and written rules but true understanding of the business and vigilant supervision on the part of its managers rings true once more.

Every major financial institution that I have come across since the collapse of Barings has made a detailed review of their systems of risk management and internal controls. I am impressed by this speedy response. I shall therefore devote my remarks to the regulatory response to the Barings collapse. It is worthy of note that whilst the failure of management has been clearly described in the Barings Report, the failures in the system of regulation have been less clearly articulated.

We know for certain that an exception was allowed to Barings in respect of the legally imposed large exposure limit of 25% of its capital base on the basis of assurances from Barings management but pending review of the overseas exposure. In the event this review never took place. Clearly the exposure, which proved fatal, was very large indeed. That was, as noted in the Report, an error of judgment on the part of a member of the banking supervisory chain. But, error of judgment apart, the Report fairly points to the fact that Banking regulators primarily look to capital adequacy and were not attuned to the day-to-day risks involved in securities and futures transactions. The Report therefore point, quite rightly, to the need for better co-ordination between banking and securities regulators.

I cannot agree more with this conclusion, but we in Hong Kong, face a special problem. Whereas the securities and futures activities of a UK bank are regulated by the UK Securities and Futures Authority, banks in Hong Kong are exempt from regulation of the Securities and Futures Commission. When the Securities Ordinance was enacted in 1974, it was envisaged that banks would only deal in securities as an incidental part of banking business. For example, banks acted as custodians of securities or accepted or disposed of shares or other documents of title in securities as loan collateral. Thus the Ordinance envisaged banks being exempt from licensing under the Securities Ordinance. The situation has however drastically changed in recent years. Banks now offer services, as either agents or principals, to their clients in the sale and purchase of securities and derivative products. In so doing, they raise two sets of issues. The first is the effect such activities have on their soundness as financial institutions, and the second, is whether their conduct as intermediaries in securities and derivative transactions should equate with licensed institutions which are not banks.

The Oversight of Financial Soundness

The oversight of financial soundness requires firstly, ability on the part of regulators to ensure that adequate internal controls are in place in a financial institution; secondly, formulation of capital adequacy rules which are sensitive to market conditions; thirdly, a system to ensure that financial reporting is adequate and timely, and fourthly, effective co-ordination between regulators, if more than one exists.

Internal Controls

As to internal controls, you will, by now be familiar with the G30 recommendations which formed the basis of the guidelines on risk management and internal controls jointly issued a few months ago by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC). A subsequent Survey by the HKMA shows an impressively high level of compliance with the Guidelines. The SFC Survey has not yet been completed and I look forward to publishing the results.

There is within Hong Kong a consensus, proven to be absolutely correct in the light of the Barings Report, that controls should include informed management oversight throughout the management strata up to the highest levels, effective understanding and clearly defined lines and divisions of responsibility and accountability, an independent risk management function and a strong and experienced internal audit function which should liaise closely with external auditors. Specifically, it is commonly agreed that internal control must be exercised vigilantly, particularly when staff performance is heavily geared to profits. Furthermore, proprietary trading should be clearly distinguished from client trading and there should be a clear division between front and back offices.

The SFC will extend its on-site inspections relying on the risk management and internal control guidelines issued earlier this year, and on the more detailed guidance on internal controls which we shall publish later this year.

Capital Adequacy

Coming to capital adequacy, you will agree that in securities and derivatives transactions, price fluctuations and hence market risk fundamentally affect a firm's ability to function on a sound financial basis. Capital adequacy rules should therefore take into account capital available to meet not only vested but also potential liabilities - namely, the payables as well as the potential payables. At the same time, the imposition of capital requirements should not be so onerous as to place undue pressure upon an intermediary to take high risks in order to seek high returns. A reasonable balance will clearly have to be struck. A start has been made by the SFC by recently amending the Financial Resources Rules (FRR) to cater for the treatment of assets and liabilities arising from options trading on the Stock Exchange. These amendments take account of net open positions. In relation to market makers in the Traded Options Market in the Stock Exchange, the SFC will be prepared to consider the adoption of the net positions produced by proprietary hedging models for all relevant exchange traded products. In making these revisions we hope we have struck a reasonable balance between capturing market risks and effective employment of capital. Of course, these revisions refer only to exchange traded products where we as regulators can still rely on the Exchanges, and their Clearing Houses in particular, as the front line of risk management. In over-the-counter trading of derivatives a much more complex set of considerations will come into play and there is no clearing house to manage the risks. Here, a wide range of derivative products is being bought and sold and the problem of quantification of potential liabilities becomes complicated indeed. However, even here, recent developments within large international financial institutions and international collaborative efforts among regulators and the industry point the way to a solution.

International financial institutions are more and more disposed to managing their client and proprietary transactions on a global basis. Many institutions that I have recently come across have already gone to global portfolio and risk management. The benefits are obvious:

risk as well as deployment of capital can be managed on a global basis. For regulators whose powers are restricted by national boundaries, this raises the urgent need for collaboration in the following respects:

- The development of consensus on quantification of risk as part of capital adequacy.
- The financial reporting framework for subsidiaries and conglomerates.
- The development of standards of conduct.

The International Organization of Securities Commissions (IOSCO) and the Bank for International Settlements (BIS) have been working on achieving international consensus on these issues. Recently, a Tripartite Group has been formed to include insurance regulators. At the same time, in the United States six large securities firms have formed a Derivatives Policy Group to help US regulators formulate risk quantification models, and framework for internal control and financial reporting. The Futures Industry Association has also developed a series of recommendations for exchanges, intermediaries and their customers. Hong Kong has been playing a very active part in this international effort and we will continue to do so.

Co-operation between Regulators

In conclusion, let me now return to the special problem of banks in securities transactions. Because of the passage of time, you may now have forgotten that in 1991, the SFC completed public consultation on the issue and concluded that there was general support for the proposition that where banks engage in securities activities beyond securities dealing incidental to mainstream banking work such as lending and custodianship, they should be regulated in the same way as securities intermediaries. The logic is perhaps obvious: less so for level playing field reasons, the public must be entitled to the same level of protection. In order to implement this, legislative amendment was deemed necessary. The revisions have been included in the legislative rationalisation exercise recommended by the 1988 Securities Review Committee. This exercise is nearing completion and a consultation should begin early next year. Meanwhile, we should in the near future be concluding a Memorandum of Understanding with the HKMA so that we may lend assistance to the banking supervisors of the HKMA in their general supervision of the securities activities of banks.

I have just given you a quick view from Hong Kong's perspective of the shape of some of the things to come after Barings.

ANTHONY NEOH

The Domain of Securities Law

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International Symposium on China's Forthcoming Securities Law
China Securities Regulatory Commission
Beijing, 16 July 1996

This Conference has come at a time when the nation is taking stock of the development to date of its capital markets and is pondering the best system of securities law for the future. I am sure that the Organisers will be able to draw from the collective wisdom of the participants and thus perfect their own thinking.

We in Hong Kong have also been involved in a limited form of legal reform.

We have in April this year published for public consultation a proposed Composite Securities and Futures Bill consolidating eight pieces of legislation that the Hong Kong Securities and Futures Commission is charged with administering. Although this proposed Bill is essentially a piece of consolidation legislation, there are a few important innovations including powers much needed to regulate electronic trading facilities, unified licensing provisions applicable to all types of financial services regulated by the Commission, and most important of all, a modular form of construction of our legislation so that innovations of the future can be added as new modules. This piece of legislation will provide practitioners and the general public with a "one stop" reference point for the core of our securities law and will be a good platform for future legal reform.

We have also therefore been doing some of our own thinking on what securities law is about. I have therefore chosen, perhaps rather ostentatiously, to entitle my address, "The Domain of Securities

Law" not because I believe I can definitively define the boundaries of a living subject, that in fact is impossible, but because I hope that in so doing I can provoke thought both on my own part, and hopefully, also on the part of those attending this Conference.

Securities law, like all laws, seeks to bring order to behaviour. The behaviour which securities law seeks to order arises from markets and those who use them. It is therefore important that we first look at what markets do and attempt to state the conditions under which our markets are most likely to grow in the years to come.

Vast Potential

There cannot be any doubt that the securities markets of our nation will grow in the years to come to many times their present size. By World Bank statistics published in 1995, the country's stock market capitalisation in 1994 was 9% of GDP and total debt market value was 7% of GDP, whereas compared to the UK, the figures are 116% and 35% respectively and compared to the United States, the figures are 75% and 110% respectively. Undoubtedly there is much room for growth.

Drawing further from World Bank estimates, the need for capital to build infrastructure alone will be US$774 billion from 1995-2004, and China's demand for imports will be US$2 trillion from 1995-2004. So, undoubtedly there is much need for growth of our capital markets.

Our nation's 1995 Five Year Plan and the 2010 Strategic Vision has set a true course for the nation's development which recognises these infrastructure and import needs and the consequential need for development of the capital markets.

Eight Fundamental Features of Successful Markets

As I am not an economist, I will not try to enter into a formal discourse as to the workings of markets. But as a regulator, I would venture to suggest eight fundamental features of successful financial markets:

- *First*, financial products are in the final analysis bundles of information, so financial markets are markets of information. The more fairly, freely, and accurately is information disseminated, the more likely it is that a financial product is bought and sold at its true value. This fundamental feature of financial markets is often called its "transparency". All successful markets have a high degree of transparency.
- *Second*, financial transactions like all transactions must be executed with the greatest possible speed at the lowest possible cost. In other words, transactions must be executed efficiently. No market which is inefficient will last for long.
- *Third*, markets are where the exchange of product and funds take place. This exchange seldom takes place simultaneously with the sale. Buyers and sellers could be hundreds or thousands of kilometers apart. It also takes time for a seller to get ready his product and a buyer to get ready his funds for the exchange. No market can exist for long without guaranteeing the certainty of this exchange, namely, the certainty of settlement of the mutual obligations of a sale.
- *Fourth*, as financial products are traded in the markets, they fluctuate in price. The time lag between sale and settlement exposes market participants to the risk of price fluctuation. This risk is multiplied if financial products are bought and sold with borrowed funds or if the products themselves represent contractual rights and obligations dependent upon fluctuations in the markets. No market can exist for long if it did not have a good system for managing such risks.
- *Fifth*, financial products are usually bought and sold through intermediaries. Intermediaries therefore handle their clients' property, whether it be money or documents evidencing title to

a financial product. Intermediaries thus owe duties to clients, and since they also participate in the markets, they owe duties to other market participants. No market can exist for long if there is no confidence placed on such intermediaries. Thus every market has business conduct rules which on the one hand, seek to protect the clients of intermediaries, and on the other, seek to protect other market participants.

- *Sixth*, financial markets require a clear system of rules which are effectively and consistently enforced so that rights, obligations and duties exist not only on paper but also in fact. No market can exist for long without this important feature.
- *Seventh*, financial markets require skilled practitioners. These practitioners should include intermediaries skilled in buying and selling financial products but also intermediaries skilled in investment management. In addition, there must be skilled supporting professionals in law, accounting and commercial and investment banking. No market will advance without a skilled corp of market and supporting practitioners.
- *Eighth*, financial markets require informed investors who understand the risks and rewards of different types of financial investment as well as what their rights are as clients of intermediaries. This understanding in turn makes demands on intermediaries so that if they do not improve, business would go elsewhere. A market without a sufficiently large number of informed investors will never mature and will never truly grow.

The system of securities law of any jurisdiction should enable its financial markets to acquire the above fundamental features. In time I am certain that the system of securities laws of our nation will succeed in creating the right conditions for growth of our markets. Meanwhile, let me suggest that in building the systems of the future, we might first consider two sets of questions:

- What should be regarded as the proper domain of securities law?

- What are the considerations which should be taken into account in deciding the structure and substance of a specialised securities law?

The Domain of Securities Law

I would like to stress that we should look at securities law as a system rather than as a single law, since securities law must exist as part of a legal system. As to what constitutes the general domain of securities law, I would suggest that we might envision the system to consist of concentric rings:

- *First*, I would suggest that at the centre ring is the general law in our legal system which defines civil capacity, rights, obligations and duties. I would regard the domain of the civil law as constituting the foundations of our system of securities law.
- *Second*, at the second ring should be one or more (preferably one) law which deals specifically with the regulation of securities markets and their participants. This is what most countries call "securities law" but I put this at the second ring because at the centre of all things is the civil law.
- *Third*, further out from the centre are all other laws which affect rights, obligations and duties in relation to securities products. For the purpose of illustration, the Joint-stock Company Law, laws and regulations relating to accounting standards and valuation of property, bankruptcy law, and laws and regulations relating to banking particularly in relation to the provision of credit and negotiable instruments.

Practitioners and legislators should not forget that no specialised securities law stands alone. Therefore, they should not forget to take account of developments in the civil law and other law relating to financial products. But since we have only limited time, let me now explore the second ring and also the second set of questions: the structure and substance of a specialised securities law.

The Definition of Securities

The obvious first question to ask in relation to a securities law is what constitutes the concept of "securities". Many jurisdictions, including Hong Kong, have not found the task an easy one because it is sometimes possible to construct a derivative financial product which falls outside the legal definition and thereby evade regulation. The tendency around the world has therefore been to give the widest possible definition to the term "securities" so that as many derivative instruments as possible might be caught. However, problems will probably arise if either there are separate exchanges trading securities and futures or if there are separate public agencies regulating futures and securities. In the first case, we have witnessed heated litigation between the Australian Stock Exchange and the Sydney Futures Exchange. In the second, the SEC and CFTC of the United States, despite the Shad-Johnson Accord, continue to struggle to define the boundaries of regulatory oversight between the two agencies.

This definitional issue has led to a number of organisational and legal solutions.

Organisationally, many jurisdictions have opted for a single regulatory agency overseeing both securities and futures markets and their participants. This model has been adopted in the UK, Europe and nearly all Asian countries which have capital markets.

Legally, the definitional solutions have not been as uniform. Whilst every jurisdiction tends to use wide definitions for the term "securities" and "futures", there have been few which have made specific provision to deal with derivative products which fall into or out of both definitions. This has led the Thai Securities and Exchange Act to reserve to the Thai SEC the power to designate any financial product a "security". That is a neat legal solution but one which some jurisdictions may find difficult to enact into law since it might be perceived as giving too much power to a regulatory agency. In the United Kingdom, the solution is not to use the term "securities" and "futures" at all but the wider concept of "investment" which is defined by a long statutory list which could be added to or subtracted from by Ministerial Order. In Hong Kong, our Composite Securities and Futures Bill propose that our exchanges may in addition to their core products trade any product approved by the Securities and Futures Commission.

Banking vs. Securities Regulation

The next issue which commonly arises is the division between banking and securities regulation. That has not been a problem for over 60 years in the United States in view of the prohibition introduced by the Glass-Steagall Act against securities dealings by banks. Thus banking regulation and securities regulation has proceeded side by side save when the payment system is involved in settling securities transactions or when the banking system is involved in credit extended to securities transactions.

In Europe, banks have traditionally been the principal intermediaries who conducted securities dealing either on behalf of themselves and/or on behalf of clients. Thus banking regulators have also included the regulation of these activities in their banking regulation work. As non-banking securities market intermediaries are established, many European countries (and many Asian and Latin American countries) have set up dedicated securities regulatory agencies. Not surprisingly, the first question which these countries have had to face was whether banking regulators should continue to regulate the securities activities of banks. Every country which had been faced with the question had answered the question one way: that the banking regulator will be the primary regulator of the bank for the regulation of its banking business and its financial soundness, but the bank's securities activities would be regulated by the securities regulator. The reason for such unanimity is quite simply that effective regulation has to be focussed. Banking regulation focuses primarily on financial soundness of a bank whereas securities regulation primarily focuses on conduct in the market and conduct to clients. Furthermore, the securities industry is changing rapidly with advances in technology, and only a specialised regulator can be expected to keep up.

Eight Fundamental Decisions

Since effective regulation has to be focussed, so it is important that the functions of a securities regulatory agency should be clearly and fully defined. I would suggest that we might focus on eight fundamental decisions which will have to be made in constructing a securities law.

Decision 1: The ambit of activity oversight

The first decision that is needed is the ambit of activity oversight, i.e., whether it is securities alone or securities and futures or securities and such other types of investment as may be specified by the State Council. The first exposes the securities law to the definitional problems I have earlier alluded to. The second gives the agency a wider berth. The third is obviously the most flexible.

Decision 2: The ambit of institutional oversight

The second decision that is needed is the ambit of institutional oversight: i.e., what are the types of market organisations and participants it is intended to regulate. It is usual to include exchanges, clearing houses and the intermediaries involved in the activities over which the agency has regulatory oversight. It is also usual to exercise institutional oversight by way of licensing powers so that conditions could be placed on the licences and failure to observe such conditions would result in appropriate sanctions, including fines, suspension and in the worst cases, revocation.

Decision 3: The ambit and substance of personal oversight

The third question to consider is the ambit and substance of personal oversight. The essential limitation of institutional oversight is that it is often socially impossible to revoke the licence of an institution which has many clients and employees. This is the same issue which faces nations which are able to exercise the nuclear deterrent: namely, no one wants to use a nuclear weapon. Thus institutions have a tendency to test the limits of regulation. This and the further reason that all institutions in the end work through individuals, really means that there should be some means to regulate the conduct of individuals working either as employees or agents of regulated institutions. This could be achieved by a system of licensing either directly by the regulatory agency or by a Self-Regulatory Organisation such as an Exchange, on behalf of the regulatory agency. Usually, licensing conditions require the observance of a "Code of Conduct" and maintenance of the qualifications of a conduct and educational nature which had made a licensee "fit and proper" to be licensed in the first place.

Decision 4: The ambit of regulated conduct

The fourth decision that is needed is the ambit of regulated conduct beyond the ambit of the institutional and individual licensing system or any system of self-regulation. In the former case, conduct is enforced because every licensee needs to maintain good standing. In the latter, conduct is enforced by agreement among the subscribers to the self-regulation system. Misconduct not caught by these two situations normally relate to the use of fraudulent devices in securities dealing, such as insider dealing and creation of false markets. It will be necessary to decide on the types of conduct which should be prohibited and what consequences should be visited upon the perpetrators. Here many jurisdictions have legislated for both criminal and civil sanctions which the regulatory agency concerned may pursue in the courts. I do not think I need say more than stress that sanctions have to be sufficiently strong to be effective. Thus criminal sanctions in most countries tend to include heavy fines and imprisonment. Civil sanctions tend to include civil penalties of up to three times the profit made from illegal dealings.

Decision 5 : The ambit of powers

The fifth decision relates to the ambit of powers outside those prescribed for the licensing system. It must be acknowledged that a regulatory agency without power is like a tiger without teeth. Therefore, the following five types of powers are usually given to securities regulatory agencies:

(i) *Investigatory powers*: enabling the regulatory agency to investigate anyone suspected of failing to comply with any aspect of the securities law.

(ii) *Directory powers*: enabling the regulatory agency to direct a licensed person or institution to undertake business in a manner directed by the agency so as to protect investors or to protect the integrity of the financial markets.

(iii) *Prosecutorial powers*: enabling the regulatory agency to commence criminal and civil actions in the courts to punish or to recover compensation for or to prevent misconduct.

(iv) *Mutual assistance powers*: enabling the regulatory agency to investigate on behalf of an overseas agency persons or institutions involved in misconduct in the markets of an overseas agency, on a reciprocity basis.

(v) *Rule making powers*: enabling the regulatory agency to spell out in detail how certain provisions in the securities law may be complied with. Most jurisdictions have a negative vetting procedure for such rules, namely, that they are communicated to the legislature or other organ of state which may within a specified time amend or repeal the rule.

Decision 6: The ambit of protection

The sixth decision which is needed is the ambit of protection to be afforded to the regulatory agency and its officers. Because financial markets are so sensitive to information, all kinds of pressures are liable to be exerted on a regulatory agency for information as to its investigatory activities. In addition, because so much is often at stake in the financial markets, regulatory agencies and their officers are liable to become targets of litigation. Therefore, it will be necessary to introduce in the law, a prohibition against disclosure of information relating to investigation unless strict conditions are met as well as immunity against legal action where the Commission and its officers have performed their duty in good faith.

Decision 7: Adjudicatory machinery

The seventh decision is to decide on the types of adjudicatory machinery needed to deal with misconduct prescribed in the securities law. It will be necessary to consider whether in addition to the courts, independent tribunals should be formed to deal with appeals from licensing decisions or whether arbitration can be used for civil actions.

Decision 8: Regulatory philosophy

The eighth decision is whether regulatory philosophy should be included in the securities law. Many jurisdictions do in fact do this by including in the functions of the regulatory body general statements of regulatory objectives. In our proposed Composite Securities and Futures Bill, we have proposed to include a number of general statements of regulatory philosophy to help us focus on our task at all times.

In making these eight decisions, I would add one caveat. It must be remembered that markets are in a constant state of flux. Thus legislation should be drafted with sufficient flexibility to reasonably accommodate market innovations and other changes of circumstances.

Conclusion

I hope that the above brief discussion of the eight features of successful markets and the eight decisions which might have to be taken will in some small way provide a degree of focus to the discussions of the distinguished participants of this Conference. There is of course no magic to the number of features and decisions that I have sought to set out. As you proceed you may either add or subtract to the numbers but I hope that the number 88, which is a very lucky number, at least for the financial markets, will provide an auspicious start to these proceedings.

Anthony Neoh

Invest Wisely: The SFC's Investor Education Programme

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Financial Women's Association of Hong Kong
31 July 1996

Today I'd like to discuss an issue which to date has not been closely examined in Hong Kong - namely the need for investor education.

Why Investor Education?

"Why do we need investor education in Hong Kong?" you may ask. That need, as I see it, is based on three factors.

Well-informed Investors

First, efficient financial markets require well-informed investors who understand the risks and potential rewards of different types of investments as well as their rights as clients. Informed investors look beyond the packaging of a financial product to see what's inside. Informed investors know their financial priorities and ask the right questions when choosing their broker or adviser or their investments. In doing so, these investors make demands upon intermediaries resulting in more business going to those who can meet their needs and less going to those who can't.

Those of you in the brokerage industry know the positive long-term effect that educated investors have on the market. In a recent speech to US retail investors, SEC Chairman Arthur Levitt enumerated the benefits: "A greater number of first-time investors, starting at a younger age. A more stable market, with sophisticated investors riding out down markets. And as investors learn to avoid frauds and uneconomic deals, more money will flow to legitimate businesses that create jobs and wealth and strengthen the economy."

SFC Investor Survey Results

The second factor behind the SFC's investor education effort are the results of a recent SFC survey of retail investors in Hong Kong. That survey, copies of which I've brought along today, revealed that few adults in Hong Kong are aware of the array of investment opportunities available or of the risks and potential awards of those products.

Almost one in three Hong Kong adults was unable to nominate spontaneously - without prompting - a personal investment other than property. Even among those who could identify specific financial products, many confessed to knowing "very little" about that product or class of investment. The survey also revealed that people had insufficient knowledge of their rights as investors and little if any understanding of the regulatory system itself.

As you might expect, this low level of awareness is reflected in low levels of participation in any investment form. Six in ten Hong Kong adults had never invested in any financial products other than Hong Kong dollar deposit accounts in the last three years, and seven in ten had not been active in the past 12 months. Even among current investors, 26% do not intend to invest in the next 1-2 years.

You may also be interested to know that the most popular investments cited were - in order of priority - foreign currency savings accounts, stocks and investment-linked insurance products.

Lack of Knowledge/Confidence

The third factor behind the need for investor education stems from the second. Successive surveys have shown retail participation in the Hong Kong stock market at 7% to 9% of the adult population and now hovering at between 30-35% of market turnover. The main reason given for this low level of participation has been two-fold: the public's lack of knowledge about financial products and their lack of confidence in intermediaries.

Together, these factors led the SFC to conclude that a program of investor education was not just a good idea, but a necessity. Regulators in a number of developed markets including the US and Australia have made the same conclusion, recognizing the importance of encouraging informed investment in their markets.

As an organisation charged with investor protection as well as the encouragement of greater participation of investors in our markets, the SFC feels that it is our task to keep investors well informed and at the same time facilitate public education work by market bodies such as the exchanges and industry organisations.

What's crucial is that there be a partnership between regulators, exchanges and the industry in this process because it's in our collective interest to do so.

Our Key Messages to the Investing Public in Four Steps

In light of this background, the SFC has formulated the following key messages to the investing public, which based on the results of our retail investor survey, we believe is best conveyed in four steps. Most of you here are no doubt very familiar with the dos and don'ts of investment, but let me go through the main points of our message with you, so that if you think we can improve upon our message, you might let me know.

Step 1: How to Make Your First Moves Towards Investing

The first step is "How to Make Your First Moves Towards Investing." We advise investors to start by *setting priorities*, such as determining their goals (for example, saving for retirement versus preserving capital for a near-term commitment), their time horizon, and the level of risk they are willing to take, which will depend on such factors as job stability, age, and investment experience.

If you do not clearly identify your priorities, you could end up with a financial product or portfolio which is not suited to your needs - for example, a 10-year investment plan with penalties for early withdrawal will not be suitable if you think you might need to draw out money in the shorter term.

We also advise investors to *balance the risks against the returns* by diversifying their investments through a balanced portfolio approach rather than putting all their eggs in one basket. In addition, we ask investors to *'know' their investments.* This means *doing your homework* by evaluating the potential profitability of your investment and understanding the nature of the investment offered to you by reading the offer document (if there is one). Otherwise, always get the facts before trading. When you trade derivative warrants, for instance (which are very popular in Hong Kong but not recommended for novice investors), know who the issuer is and its financial standing.

Step 2: Choosing the Right Expert to Help You

After deciding what type of investment you wish to make, you need to choose a good broker or financial advisor. First, you must *make sure the person and the company you deal with are both properly licensed with the SFC.* The SFC's licensing regime imposes entry and ongoing requirements on registrants. An SFC licence, nevertheless, is not a guarantee either of honesty or future performance on the part of a person or company. An investor may still suffer loss due to the inefficiency, carelessness or negligence of an intermediary.

Before I go any further, let me be absolutely clear that the vast majority of people selling financial products are honest. There are many financially secure individuals who can thank their brokers for putting them on the right track long ago, helping them to plan for a comfortable retirement, their children's education, or other important investments.

Nevertheless, there are some people in the industry who do not always have their clients' interests at heart, or worse, and they can do enormous damage. That's why the best advice we can offer investors, is to ask the right questions of their broker or adviser. For example, they should ask up front about:

- the category of licence held by the intermediary;
- fees and charges;
- the grievance channels available if they are dissatisfied with the service they are receiving or if there is a dispute; and
- how their assets are held.

Prudent investors should also "get it in writing" by making proper, contractual agreements before trading. Furthermore, always ask for a clear explanation of the agreement's contents, in language you fully comprehend, and make sure you understand and agree with it before signing.

Step 3: The Importance of Monitoring Your Investments

Once you have invested, it is important for you to monitor your investments and this goes for the novice as well as the seasoned investor. How many of us have invested in what we thought was a safe long-term investment, only to lose track of its performance or the way it is being managed?

Monitoring your investments means being vigilant. Give clear instructions, check your transaction advice, contract notes, statement of accounts and last but not least, be alert to signals that things are not going the way they should; for example, the person with whom you are dealing suddenly becomes inaccessible, trade confirmations have been hand-amended or, instead of receiving a cheque for settlement of sale, you get excuses.

Step 4: When to Pursue a Complaint

Under such circumstances, you may wish to pursue a complaint. Investors can play a key role in enforcement and regulatory action by alerting the SFC to malpractices they encounter. The SFC has successfully exposed many abuses within the industry and punished the individuals concerned; many of these successes have stemmed from complaints from the public.

Certainly, investors can air their grievances through other channels, for instance to the senior management of the company concerned, or if they are dealing with a member of either the Stock or Futures Exchanges, they can contact these self-regulatory bodies.

The SFC maintains a Hotline which investors can call if they have a complaint about a registered person. All reports are treated as strictly confidential. We then carefully assess each case and act accordingly. Our Hotline number is 2840-9333.

Despite the SFC's willingness to deal with such complaints, part of our investor education role is to explain to investors what we can't do to help them and what they must do to protect themselves.

For instance, the SFC does not have the legal right or obligation to arbitrate or intercede in civil disputes between investors and intermediaries, and so can do little to assist in the recovery of lost investments. Nor can we make an order for compensation or damages.

An enforcement action by the SFC will not usually result in any monetary award to a private party, and is not a substitute for civil action for damages, which you may need to resort to if you have been given fraudulent advice.

How Do We Get the Message Across?

The four steps which I've outlined above are the subject of a series of easy-to-read booklets we've created for investors which will soon be available to the public at the SFC Counter and at all 16 Consumer Council offices. Trade bodies and intermediaries are welcome to display these booklets at their premises for their clients if they like. (I assure you that no disciplinary action will be taken if they choose not to). These booklets will soon be available on the SFC's new Internet Home Page as well. Next time you're "surfing the net", I encourage you to visit our Home Page the address of which, for those interested and with a pen ready to write this down, is http://www.cuhk.edu.hk/sfc*.

We are also considering delivering these messages through other media, including an investor education column in cooperation with a local newspaper. You'll be hearing more about these activities in the months to come.

Conclusion

For those of you concerned that the SFC's Investor Education campaign may overemphasize the risks than the rewards of investing, I assure you that is not the case. While our message to investors does point out danger signals, it does so only to encourage them to ask questions, to be vigilant, to get the best deal for their investment dollar, and - at the end of the day - to *invest wisely*.

I hope that the industry will support us in this educational effort by encouraging their clients to examine their investment options carefully. That's not just good for business; it should also go a long way towards helping the retail investor market in Hong Kong achieve its true potential.

* Presently, the website address is http://www.hksfc.org.hk
For Investor Education Centre, the address is http://www.eirc.org

Michael Wu

The Supervision and Regulation of Securities Markets in Asian Emerging Market Countries

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The Joint IMF/JCIF Seminar on Strengthening Financial Sectors in Asian Capital-Inflow Developing Countries, Tokyo, 7-9 February 1996

My presentation today is the Supervision and Regulation of Securities Markets in the Asian Emerging Markets. I am sure there are many of you with better credentials to address this gathering on the subject than I. But, the attractions of an all expenses paid trip to Tokyo clouded my better judgment and I am now here before you like a lamb before the slaughter. I hope you will be gentle with my foolishness and allow this experience to be relatively painless.

As I said, I am no great expert in the supervision and regulation of markets, not in Hong Kong and much less in the Asian emerging markets. All that I feel equipped to do is to talk round the subject by painting a broad picture of the environment in the Region to set the scene for my personal perspective of development and trends.

However, before I commence, as all regulators would insist, I should make a full and frank risk disclosure statement - a little history about my experience in the regulatory business so that you are under no misapprehension about my "level of expertise", if any. This ensures that you take what I am about to say with the proper degree of cynicism.

I first came into contact with the regulatory business after the Market Crash in October 1987, not that very long ago. As you may remember, during the October Crash, the Hong Kong market was closed for nearly a week after dropping about 10% on Black Monday. When it re-opened the following Monday, the market fell by a further 35% and the Hong Kong Futures Exchange clearing system came under severe stress when nearly half the participants in the futures market walked away from their obligations. It was only saved from bankruptcy through two rescue operations involving nearly $4 billion.

In the wake of that crisis, the Hong Kong Government set up a Committee to undertake a post-mortem. The job spec required a full report on what happened, what went wrong and how to fix it, all within six months. This was a tall order even for experts! An impossible task for a generalist civil servant like myself. I guess they were looking around for someone to be the fall guy if the whole exercise turned out to be a mess. As I was "expendable" as the saying goes, their eyes fell on me and I was given the task. I believe this to be the case because until then I had zero knowledge of the industry, not having ever invested in the securities and futures market prior to that and had little to commend myself for the job at hand. Nevertheless, I was given my marching orders and told to get on with the task. To be fair, they did put together a team of advisers, consisting of people in the industry and other professionals, to act as a sort of steering committee to oversee the project.

Having regard to my training, I did the usual thing a lawyer would do in such circumstances: become an instant expert by reading whatever books on the subject I could lay my hands on. That was another mistake - the first one was agreeing to take the job at all! The books were clearly not designed to educate. They were totally unintelligible to a lay man as they were filled with technical terms and unexplained jargons. What's more, they were all about how the developed markets in the West should in theory work. There was nothing on how markets in practice worked and not a word about how to regulate emerging markets in Asia.

A week later, I was so despondent that I treated myself to a round-the-world trip. I chose my favourite cities - New York, London, Tokyo and Singapore "to talk to market experts". That was my third consecutive mistake because I spent the next ten days getting in and out of airports, flying from one place to another and fighting a serious bout of jet-lag.

By the end of the trip, the only thing I found was that I had lost a precious month. What I thought was going to be a relatively simple task of obtaining consensus from experts regulating the most important international markets in the world on an ideal regulatory system which Hong Kong could copy, turned into a nightmare of multi-coloured strands all shooting off at different tangents. Every place I visited appeared to have a slightly different system:

- the US and UK had dedicated professional regulators while Japan and Singapore were regulated by civil servants;
- the US, Japanese and Singaporean regulators were paramount while the UK had just undergone "Big Bang" and devolved most of its regulatory authority to a plethora of SROs;
- the US relied heavily on black letter laws, the UK on the so-called "raised eyebrow", while Japan and Singapore relied heavily on administrative edicts;
- the US and Japan had Glass-Steagall, the Germans and Swiss went the other way and had universal banking while the UK and Singapore were somewhere in the middle;
- Japan and Singapore had fairly high capital requirements for their intermediaries, the US had moderate requirements while the UK had fairly minimal requirements;
- the US market had specialists, the UK had market makers, the Japanese had *Saitoris* and Singapore had the MAS; and
- the US and UK were quote driven markets while Singapore had an order matching system and Japan was somewhere in between.

I can go on like this for hours, but I shall not bore you further.

Suffice it to say that not only did I find the content and form of regulation varying substantially from jurisdiction to jurisdiction, I also discovered that even the level and style of regulation in these markets differed tremendously. Yet, all these places are perceived to be well-regulated and each set of regulator honestly believed that their system was entirely appropriate. How was I going to rationalise the lot into a coherent picture?

At that stage, I was desperate. I still remember sitting in gloom watching my wife and daughter play with the new Monopoly set I bought them for Christmas. Suddenly, I noticed something odd in their game which did not quite mesh. So, I watched a bit more carefully until I discovered what they were "doing wrong". Rather than buying the place you first visited and paying on those owned by others as prescribed in the Rules of the Game, they simply took money from the bank everywhere they went.

As a diligent father, I tried to teach them how the game should be played. My wife jumped up and asked what was the fun in bankrupting a three year old? And besides, she asked, what was the point of a game with a child if the only result was to make her unhappy? So, she simplified the rules to see how fast they could together bankrupt the bank and then count the money they each made in the process. That way, they could both enjoy the game and also teach my daughter to count a bit.

I thought about it for a while and said to myself, how true! There is no rhyme or reason why you had to follow the rules of the game prescribed by other people. You could always adapt these to your own circumstances to achieve your own objectives. The key to how you should adapt these rules was of course in having clear objectives.

The universal end game in Monopoly was to bankrupt someone, anyone. The end game in securities regulation was equally universal: investor protection and systemic integrity, admittedly with some bankruptcies along the way although that is totally unintentional. These objectives applied across the markets irrespective of the form, style and level of regulation. The differences between the different markets were simply nuances or variations of the same theme. At the end of the day, they merely reflect differences in circumstances and the level of maturity of the markets. What is more, decisions regarding what level these should be pitched at boils down to a question of balance and the choices are simply your day-to-day public policy decisions which we administrators are best at.

With that sorted out in my mind, I set off to do the job at hand. We completed our study within the prescribed time-table and made some two hundred and forty recommendations to reform the market. I can honestly say that I emerged from that experience unscathed and unencumbered by any deep knowledge of how markets work or how they should be regulated. Moreover, the few years between then and now have passed by without my acquiring any more technical expertise on how best to regulate or to supervise the modern financial markets. So, you have been properly warned.

Now, to the business at hand: The Regulation and Supervision of Markets in the Region.

Generally speaking, I believe it is probably not unfair to say that with only a few exceptions, the Asian financial markets are all fairly new and recently developed. The question that many of the policy makers face at this initial stage of a market's development is "Do I go for a high level of market integrity *ab initio*, thereby running the risk of slowing down the pace of development?" or "Do I go for incrementalism, sacrificing some degree of investor protection but facilitating the pace of development of the market?" To put it another way, the choice is between the desire to start off with a higher level of protection for the relatively unsophisticated investors or to have a level of regulation which does not hamper or stifle the development of the market.

While the two objectives are not necessarily incompatible, they do often conflict. Clearly, the more tightly you regulate a market, the more difficult it is for people, investors and intermediaries alike, to enter the market, thus, slowing down the pace of development. On the other hand, the more lenient the regulation, the easier it is for people to enter but, you tend also to let in the rogues and so expose your investors to a greater degree of risk.

For most markets, Hong Kong included, the choice is rather obvious because you clearly need a market of sorts before there is anything to regulate. There is simply no sense in having a comprehensive and fool-proof regulatory system if you do not have a viable market. This is particularly true because I believe it is overstating it to say that investors will not enter a market which has little regulation. The financial market is all about risk/reward and experience tells us that the money will follow where there is the right return to justify the risk and this is irrespective of popular perceptions regarding whether a market is "properly regulated" or not. So, even the most conservative pension fund will invest some of its money in the so called "exotic markets" if the expected returns are perceived to justify the risk. Thus, for many years, while the Hong Kong market was termed a "cowboy market", the international players were there punting away merrily with the greatest gamblers of the East, the small local retail investors of Hong Kong.

Their participation in the Hong Kong market undoubtedly contributed to the growth of our market, particularly its level of sophistication. But, they also brought with them some unique problems, particularly exceptional volatility, as the international funds ebbed and flowed through the market. This is because such funds are extremely fickle: they chase after the latest "hot" market without any sense of loyalty or sympathy. As they move in and out of a market, prices and volumes surge or fall as the case may be. But, that is a reality we have to live with.

Here, I would like to digress a bit and talk very briefly about market volatility. Because of the relatively paternalistic style of most governments in the Asian Region, there is very often a higher inclination to protect their retail investor base. This desire sometimes translates itself into a paranoia about market volatility, especially among civil servants who have little knowledge of how markets work. I remember being asked by a senior government official in the Region about how best to "regulate volatility": the US idea of circuit breakers, the Japanese style limit up/limit down or the Korean method of a contributory intervention fund. I was caught by total surprise and did not know how to answer, at least not in sufficiently diplomatic terms to avoid embarrassment to my Government.

He had clearly come to the wrong person for an answer to what was a legitimate question. He had obviously forgotten that we in Hong Kong are the most free-wheeling market-oriented economy in the world and frown at anything that even remotely smacks of interference with the market mechanism. We live and die by the creed that any such action renders the price discovery function of the market ineffective and cannot be contemplated. For this reason, we in Hong Kong are relatively insensitive to the presence of volatility in our markets, particularly as we firmly believe that the worst thing outside an inactive market is a predictable market. In any event, regulating totally predictable markets is a thankless task as those with the heavy artillery, i.e. substantial funds to play the market, inevitably wins to the detriment of the small retail investors, the people most regulatory systems set out to protect.

The real answer to market volatility in our view is greater diversification, both in terms of products and in terms of sources of investments.

The full complement of financial products, particularly derivatives, presents the market with a wide range of risk diversification and risk transfer tools, thereby making the market more stable, systemically speaking of course; while a variety of sources of investments affords the market with a diversity of views and perceptions regarding prospective trends. As these interact in the market, hopefully they cancel each other out as the sentiments of one particular segment or another change. This way it should be possible to avoid wild fluctuations in the market. These factors, coupled with a robust risk management system, helps to ensure systemic stability even in times of extreme market volatility.

However, recognition of the fact that we have to live with highly volatile markets means that the Hong Kong regulators tend to have to monitor the exposures being built up in the market much more closely than our colleagues in the West. Also, we have to go to greater extremes to satisfy ourselves that these exposures are adequately covered on a market-wide basis.

I stress "on a market-wide basis" here because securities regulators are resigned to the fact that at some point or another, some intermediaries will go to the wall. Unlike banking regulators, we make no attempt to stop such occurrences, although we do try our best to avoid them where possible. The thing that we have to do is to ensure that when a firm goes down, it does not bring the system down with it. That is the essence of systemic integrity.

Thus, as markets mature, you inevitably start to worry about market integrity. For one, as the market grows to a certain size, concerns regarding the build up of risks in the market begin to rear its head. A simple lesson from Barings' collapse last year is that you should never allow a single player to have half of your open interest however big it is and whatever its financial resources. The business activity they offer may be attractive but you are sitting on a time bomb. To ensure that this does not occur, you need safeguards and systems.

For another, the market will refuse to grow beyond a certain size unless the institutional investor, particularly the international institutional investor, is willing to come into the market in a big way. Very often, they, especially the large US pension funds, are prohibited either by law or their constitutive instruments from entering a market in a major way unless the market is regarded as "well regulated" and systematically sound. Thus, to attract these investors, you have to start getting the market onto a more solid basis by introducing appropriate regulation.

Most of the markets in the Region are actually at this second stage. The roots of their markets have taken hold and their markets are steadily expanding. They are now devoting energy to improving their supervisory standards and regulatory capabilities to enhance market integrity.

To those who are looking at how best to achieve this, a warning note from my 1987 experience: while it may be tempting to look West for inspiration in this process, you should bear in mind that their systems operate within a totally different environment, an environment which more often than not cannot be replicated in the Region. Thus, wholesale importation of so-called international regulatory systems and standards into the Regional markets are totally inappropriate.

Take, for example, the disclosure-based system in the US. It works there because they have a sophisticated information system that operates real time so that disclosures of price sensitive information in the market place are quickly disseminated. A highly developed research and market analysis industry help digest the information so that their assessment of the implications of such disclosures are reported equally widely and the market can then react to the news in a timely manner. Such a system, particularly the research and analysis capability, is basically absent in the Region. But, it is such support services which render the system effective. So, our ability to go to a disclosure-based system is severely handicapped not so much because of the absence of regulatory will or the lack of investor maturity as many Western commentators would have it but because of inherent deficiencies within the industry.

In addition, the developed markets in the West are generally institutional in nature whereas the markets in the Region are still predominantly retail. This difference changes the nature of the market fundamentally because the retail investor tends not to be able to follow the market as closely and is, therefore, much less capable of reacting in a timely manner to such disclosures even if the same machinery exists in our markets.

Furthermore, in the West, ownership and management of companies tend to be quite separate whereas the majority of companies in the Region are still relatively closely-held. This again militates against a disclosure-based system because the natural check and balance between ownership and management of listed securities does not exist in the Region. The policing role is left largely to the regulator in the Region. This puts additional demands on our regulatory and supervisory systems and have the effect of making us appear much more interventionist than is the case. For this reason, the Regional regulator is often perceived to be much more heavy handed when compared with our counterparts in the West.

Finally, my experience in the industry over the past six or seven years is that the level of professionalism of the practitioners in the Regional markets is markedly lower than in the West. This is not meant as a criticism of the abilities of the local practitioners because the local practitioners can easily hold their own against the best in the world. What I mean is that, for whatever reason, even respected names in the West tend to apply lower standards when they operate in our markets and would, very often, decline responsibility where these are assumed by them without question in the course of their daily business in their home jurisdictions. The net effect of this is that the quality of some of the disclosures of the companies in our markets and particularly the reliability of the so-called "independent advice" tend to be much lower than in the West. This, too, militates against adopting such an approach in the Region.

The combination of these differences is that the built-in safeguards or the so-called self-regulatory function of the players in the market is much less dependable in the Regional markets. To afford our investors with the same degree of protection, this difference again obliges our regulators to be much more interventionist when supervising market activities than appears to be necessary in the West.

A fact that we have to be alert to when considering how best to regulate and supervise our markets is that the retail investor in the Region tends to base his investment decisions much less on economic fundamentals and research than his counterpart in the West. Markets in the Region are much more "rumour driven". This has two major implications for regulators: the first is that there is a much greater tendency for prices and volumes of individual stocks to cascade as rumours fly through the market, wreaking temporary havoc on short-term market volatility and threatening systemic stability. Intra-day volatilities of up to 10% are common affairs in our markets. Such occurrences outside what they would term as a market collapse are rare in the Western markets. Thus, our risk management systems need to be much more robust.

The second is that surveillance against insider trading becomes much more difficult because nearly everyone appears to be trading on rumours from ostensible insiders, for example, the friend of the wife of the driver of the controlling shareholder. So, our market surveillance team works constantly in overdrive. This also means that the effectiveness of the Western style moral censure in being identified as an insider trader in the Regional markets is highly questionable within our environment. We are, therefore, obliged to look for alternative responses to such malpractices.

Another fact that we should be alert to is that the Asian investor tends to be much more disinclined towards divulging his investments. He will go to great lengths to hide his shareholdings, even where there is no regulatory motivation for doing so. As a result, our markets are much less transparent. This makes a nonsense of the client identity rules which are standard in the West and renders regulation of takeovers and mergers much more difficult. In addition, minority shareholder protections, such as regulation of non-arm's length transactions, are much less effective in our markets.

One fundamental difference between our markets and those in the West that I take pride in and a lot of comfort from is that the small retail investor in the Region is much more robust than his counterpart in the West. He will take a loss without flinching as long as he knows that he has not been cheated. In the West, they will run to their regulator, or worse still, their Member of Parliament, crying foul and seeking recompense. For this reason, things like suitability rules and arbitrations are much less developed in the Region. But, I am not sure this is necessarily a bad thing or that it makes our investors less sophisticated. I honestly believe that they are equally sophisticated but in a difference sense - they are street-wise and much more adventurous, making our markets more interesting.

Unfortunately, I also believe that their days are numbered because as our markets open to the West, they are increasingly being pitched against players who have substantially deeper pockets and who have much better resources, rocket scientists and PhDs in maths working with the most advanced computer models. The derivatives explosion in our financial markets during the past few years has also swung the battle against their favour. The danger this holds for our markets is that they will grow disenchanted and leave the market altogether. This would completely change the nature of our markets. The trend is a reality that we have to contend with unless we can reverse it somehow. We in Hong Kong are currently looking at ways and means to redress this imbalance.

As regulators, we also have to contend with the reality that the markets are getting to such a highly sophisticated level that we are increasingly being left behind. The Hong Kong market, with the variety of innovative products and a large over-the-counter derivatives business, is already at that stage. The other markets in the Region are not that far behind. As the markets get ever more complex and finely balanced, the important thing is to ensure that we are not left behind too much, at least not to the extent that we lose a handle over the market and become unable to regulate effectively.

We have to recognise the fact that however well resourced we regulators are, we cannot hope to compete with the market in recruiting a similar level of technical expertise into our ranks. Our pay packages are simply not sufficiently attractive. So, we are unlikely ever to achieve parity in terms of technical capabilities with the industry. Moreover, for the sake of market efficiency, we do not believe that we should erect road blocks against market innovation or attempt to regulate out market initiative. This leaves us in a quandary. Traditional methods can only take us so far, while looking West for inspiration has its pitfalls because of intrinsic differences in environment and market make-up. We have little choice but to come up with new answers to improve our regulatory and supervisory capabilities.

As the markets in the Region increasingly integrate, I believe for one that our past approach of independently regulating our own markets is clearly inadequate. Greater cooperation between us is necessary. The Regional regulators should pool their expertise, share experiences and cooperate closely with each other to enhance our limited resources. We also have to constantly improve our individual regulatory know-how to survive.

Just as the days of the small retail investor in the Regional markets are numbered, so too are the days of the generalist regulator like myself.

Laura Cha

The SFC's Role in Regulating Listed Companies in Hong Kong

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The Directors' Conference -
Review and Update on the Listing Rules
17 January 1997

Today I propose to describe the role played by the Securities and Futures Commission (SFC) in regulating companies listed on the Exchange. My talk will first cover the regulatory structure of the Hong Kong financial market, functions of the SFC and oversight of the Stock Exchange, and in particular that of the Corporate Finance Division in the SFC and our oversight of the Listing Division of the Exchange. Secondly, I will cover some of the areas that are directly regulated by the SFC. Lastly, I will touch on our relationship with our counterparts in China.

Regulatory Structure of the Hong Kong Financial Market

Under current Hong Kong law, the SFC is the statutory body entrusted with the authority and responsibilities of supervising and monitoring the activities of both the Stock Exchange and the Futures Exchange, and enforcing laws and regulations relating to the securities and futures markets.

The Stock Exchange of Hong Kong (SEHK), on the other hand, is a private organisation owned by its members but has been given the privilege by the Government to operate and maintain the stock market in Hong Kong. Prior to 1992, the Exchange shared with the SFC the responsibilities of vetting listing applications and approving certain disclosable transactions of listed companies. In order to remove regulatory duplication and as part of the SFC's efforts to restructure the Exchange, the SFC entered into a Memorandum of Understanding with the Exchange in November 1991 and devolved to the Exchange the day-to-day administration of the Listing Rules and the direct responsibilities of regulating listed companies.

Today, the Exchange is the front-line regulator of listed companies in Hong Kong.

The SFC retains a supervisory role over the Exchange and in general leaves all front-line responsibilities in listing functions to the Exchange, with the exception of matters relating to takeovers and mergers and general listing policy matters as well as any amendments to the Listing Rules. The SFC also retains its power to suspend the trading of shares under the Statutory Rules. The enforcement of other securities-related regulations such as the Securities Ordinance, the Securities (Disclosure of Interests) Ordinance, the Securities (Insider Dealing) Ordinance, the Protection of Investors Ordinance, etc., also rests with the SFC. I will go into these areas later in my talk and would like to describe for now some of the key points of the MOU between the SFC and the Exchange.

MOU between the SFC and the Exchange

The MOU sets out the obligations and the listing-related functions and responsibilities each of the SFC and the Exchange. Pursuant to the MOU, a number of mechanisms were incorporated to enable the SFC to effectively discharge its function of overseeing the Exchange's performance in listing-related matters.

There are a few key points in the 1991 MOU that I would like to describe to you today.

Restructure of the Listing Committee

Previously the Listing Committee comprised a handful of members the majority of whom were executives of the Listing Division. The MOU between the SFC and the Exchange restructured the Listing Committee as a mechanism of checks and balance on the Listing Division. The MOU expanded the Listing Committee to include representatives from various market participants such as listed company representatives, merchant bankers, fund managers, lawyers, accountants as well as stock brokers. It was intended that market participants would add to the listing process their collective experience and expertise of the market and ensure that decisions by the Listing Division are made in an impartial and professional manner.

It should be noted that members of the Listing Committee are nominated by the Listing Nominating Committee which comprises three representatives from the SFC and three from the Exchange. This is to ensure that the views of both organisations are taken into account in nominating members to the Listing Committee.

I am pleased to say that the experience and result of the work of the Listing Division in the last few years has demonstrated that this system of checks and balance has worked well.

Monthly report and liaising meeting between the Corporate Finance Division and the Listing Division

Corporate Finance Division of SFC and Listing Division work closely together and our staff often meet on an ad-hoc basis to discuss matters which have policy implications. Because the SFC no longer deals with listed companies on matters under the Listing Rules, we rely on the frequent contact with the Exchange to keep us informed. In addition, the Listing Division provides us with a monthly report that outlines their key operational matters in that month and we hold monthly liaison meetings to discuss the monthly report and other specific issues.

Periodic audit of the listing function of the Stock Exchange

Under the MOU the SFC has the authority to conduct an annual audit on the Listing Division to ensure that the Division carries out its functions professionally and in the interest of the investing public. I am pleased to say that after the initial audit in 1993, we have found that subsequent audit could be conducted every 18 months instead of annually and that the Division staff have demonstrated maturity and professionalism in carrying out their responsibilities. The audit by the SFC is also an useful tool for the Exchange to identify areas of improvement in both policy matters and in procedures.

SFC approval for rule changes

To keep pace with the development of the market it is necessary for the Exchange to amend the Listing Rules from time to time. As with all other rules of the Exchange, all amendments or addition to the Listing Rules require the ultimate approval of the SFC. In practice, the Listing Division consults the Corporate Finance Division of the SFC during the process of developing any rule amendments and the SFC is in general supportive of the Exchange's initiatives.

In summary, the restructured Listing Committee, the monthly report by the Listing Division, the periodic audit of the Listing Division, as well as the requirement for SFC approval of all changes to the Listing Rules are all part of the checks and balance that was set into the system to ensure that the interest of the investing public and the market is properly safeguarded.

What then are the checks and balance put on the SFC, one may ask?

First of all, the SFC is a public body accountable to the Government and to the public. The Board of the SFC consists of five Executive Directors and five non-Executive Directors, all of whom are appointed by the Governor for a fixed term. The SFC reports to the Financial Secretary and is answerable to the Legislative Council (LegCo).

We are often called upon to explain matters of public interest relating to the markets we regulate in front of LegCo and have to respond to investors complaints in general.

The authority of the SFC is prescribed by statute, and the staff are subject to queries by the Commissioner of Administrative Complaints (COMAC). So far we have been able to satisfactorily answer to complaints directed to us through COMAC.

Matters Directly Regulated by the SFC

Having discussed the MOU between the SFC and the Exchange, we now turn to matters which are regulated directly by the SFC.

Takeovers and mergers

Takeovers and mergers affecting public companies in Hong Kong are regulated by the SFC through the non-statutory Hong Kong Code on Takeovers and Mergers. The primary purpose of the Takeovers Code is to give fair treatment to shareholders affected by takeover and merger transactions.

Share repurchases

The Share Repurchases Code generally requires a share repurchase by a public company in Hong Kong to be made by way of a general offer to all shareholders or in accordance with an exemption from the general offer requirement. In almost all cases, public companies in Hong Kong use an exemption available for share repurchases made through the facilities of the Stock Exchange in accordance with the Listing Rules.

The Securities (Disclosure of Interests) Ordinance

The Securities (Disclosure of Interests) Ordinance (SDI) requires directors of listed companies to disclose to the Exchange their interest in the shares in or debentures of their company or any "associated corporation" (as defined in the SDI Ordinance).

Every director must also notify the SEHK his interests and dealings in warrants to subscribe for shares of the company. A director is deemed to be interested in shares in a wide range of circumstances. A director is interested in shares if he is the registered holder. He also may be deemed to be interested in shares based on corporate, family, trust and contractual interests.

Securities (Insider Dealing) Ordinance

As a measure of ensuring all shareholders of a listed company receive price-sensitive information on an equal basis, most jurisdictions have some sort of regulations prohibiting the dealing in shares of a listed company by persons having inside information. Hong Kong's legislation is the Securities (Insider Dealing) Ordinance and is enforced by the Enforcement Division of the SFC. Cases are referred by the Enforcement Division to the Financial Secretary and an Insider Dealing Tribunal is appointed to review each case.

The China Dimension - Relationship with the China Securities Regulatory Commission

In June 1993, the SFC and the Exchange entered into a Memorandum of Regulatory Cooperation (MORC) with the China Securities Regulatory Commission, the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The purpose of the MORC is to enable parties, through mutual assistance and exchange of information, to accomplish (1) the basic principles of protecting investors, (2) maintaining fair, orderly and efficient markets, and (3) to ensure compliance with each other's laws and rules. The scope of MORC therefore covers not only issuers of securities, but also directors, officers, shareholders and professional advisers of companies listed in the PRC or Hong Kong. Also within the ambit of MORC are dealers and investment advisers operating in the PRC and Hong Kong. It also covers trading, clearing and settlement activities, insider dealing, market manipulation and other fraudulent practices on any stock market in the PRC or Hong Kong. MORC also includes the training and exchange of personnel and any other matters agreed to by the parties.

Specific areas of cooperation include company news dissemination, suspension of trading, takeovers and mergers, regulation of intermediaries and standardization of securities terms. The list may be revised as and when the need arises.

Like other memoranda of understanding between securities regulators around the world, MORC contains statements of intent which do not impose legally binding obligations on the signatories. As such, MORC has no power to override domestic laws and regulations, nor does it affect other channels of cooperation. Pursuant to the terms of MORC, the parties meet once every quarter to discuss developments in their respective markets and matters of mutual interest. These meetings have already demonstrated that frequent dialogue between the parties facilitate the understanding of each other's market and the manner in which issues of mutual concern can be handled. This is of particular help in ensuring that companies which have shares listed in both the PRC and Hong Kong, are subject to the same standard of regulation by the authorities in both jurisdictions.

MARK DICKENS

15 Challenges of a Rising Market

The Rotary Club of Hong Kong Northeast
1 August 1997

I can't possibly cover all of the challenges that come from a rising market and in some ways, it's very strange that I should have to. You've all been following the media over recent weeks. You are all familiar with the details of the biggest stock market boom Hong Kong has ever known. The highlights are that Hong Kong is now the sixth largest market in the world. The index is at a record high. We have had months where stocks have been doubling, tripling and in some cases, quadrupling. But much more important from a regulator's point of view, the volume has hit record highs. Yesterday, turnover was $28 billion. Today, it looks like it might go to $30 billion. It was $15 billion when I left the office and the market was up 50 points on the previous record. It had been struggling to get there but it managed it.

So, what's a regulator doing talking about all of that? Well, in Roman days, when a General was awarded a triumph for winning a great victory, he got to ride in his chariot through cheering crowds. There was a slave whose duty was to stand in that chariot and whisper in his ear as he went, "Remember, you are mortal." That, unfortunately, is the regulator's task at times like this.

It's not our task to tell you how to invest your money or how risky it is or whether or not you should be speculating or whether speculation is healthy or unhealthy. But we do have to remind people of some of the risks that emerge. If you are unlucky enough to be in charge of the Enforcement Division, you get an even less popular job, which is dealing not just with the risk that things may go wrong but trying to identify, pursue and regrettably, punish the people who do go wrong. They are a small minority in the market but they are the majority of what Enforcement deals with.

Now, the reason that our job gets more interesting and more challenging at times like this is that the self-regulation system comes under a great degree of stress. One of the great strengths of the Hong Kong market is that by and large, it relies on self-regulation of the industry by the industry. That is the first line of defence. The next line of defence is the Stock Exchange, usually called the frontline regulator, but in fact it's the second line. Behind that is the SFC and at the very backline of the SFC, there's an enforcement function, which has about 40 professional staff with some supporting clerical staff and secretaries. The reason for pressure on all these parts of the system is not so much the rise in the index or in prices of some stocks but the rise in turnover and the rise in deal flow. The rise in turnover is associated with a big change in the nature and behaviour of the market.

Right now you have retail activity on a scale not seen for many years in Hong Kong. Some of the older brokers tell me that that reminds them of 1973 rather than 1986. And certainly our own market surveillance tends to confirm that. The market is moving from a position where it was dominated by institutional trading of blue chips to a market which is increasingly dominated by very active retail trading of a broad range of stocks in the market and moving away from the blue chips. And you will see retail investors, often with not a very high net worth, doing four or five pages of single transactions in three or four stocks a day, basically day trading extremely actively, sitting in the broker's office watching the screen, having a coffee, giving their orders. And that's where a lot of this $28 billion is coming from.

Because the market becomes concept-driven, directors of listed companies have to change the way they think about communicating with the marketplace. Information that wasn't price sensitive, such as remote plans, prospects, tentative approaches by people that might possibly lead to some business suddenly become price sensitive as does the presence of rumours about them in the market. The other great adjustment of course is that there are very few directors of listed companies who get as concerned about a rise in the share price as they do about a fall. It's very easy to take the good news as your due and not say to yourself maybe there is something wrong here, maybe people misunderstand the company, maybe I'd better check what's causing this, maybe I'd better talk to the Exchange.

Also, the corporate finance industry comes under incredible pressure. Because the market is very active, because no one knows how long the good times will last, because there's an amazing deal flow, they have less time. They are now under considerable client pressure to get transactions done, to get them through the system, to get the regulators happy. They also have less time to do due diligence. And the opportunity cost of due diligence rises. The more time they spend investigating one company making sure they're comfortable with the deal and with the numbers, the more deals they're missing out on what would come down the pipeline if they could free up the time.

Investor caution is relaxed. I have been watching the screen very closely for market surveillance reasons over the past few months and if I were an active investor, I could have expected an average return for a day of about a million dollars just from day trading the stocks that tended to move. So there has been a very quick move from the market being concept-driven by the China concept to being rumour-driven and then trading-driven. Actually, at the moment, it has been an effective strategy to buy the stocks that start moving at the start of the day and provided you watch the screen and get out quickly if it goes against you, you'll probably do very nicely. Some stocks are moving up 10%, 15%, 20%, or even 25% a day.

Now, that creates an ideal environment for that very small minority of people who will inside deal, who will manipulate the market. Insider dealing becomes very profitable. False rumours can become very productive because they move the price. And market manipulation becomes very easy to start because all you have to do is give the stock a starting momentum and the day traders will come in and do the rest for you. It also becomes much, much harder to detect.

In such a scenario, the Stock Exchange, and the SFC, especially the Corporate Finance Division, come under pressure. They have so many transactions to process, so many things to look at, so many announcements and circulars to vet, all of which have to be done in a very timely fashion. But maintaining the usual level of scrutiny is very difficult. On top of that, the corporate finance industry is not using as much care as it normally does. The net effect is that, to maintain standards of service, the frontline regulator ends up deferring disciplinary action and ends up deferring enquiry actions. That sends a signal to the unscrupulous people that they can get away with more - so that you can have a negative message in the marketplace.

So the problems come through to Enforcement. The problem with enforcement is that we are not very good at getting messages across quickly. We can't talk about our work in detail. We're subject to very strict secrecy provisions. Furthermore, enforcement is about deterring misconduct by catching people and punishing them and that takes a long time. For misconduct in 1997, the chances are any proceedings will take place in late 1998 whether they are proceedings before the magistrate or before the insider dealing tribunal or whatever.

It was to overcome these problems that the Stock Exchange and the SFC sat down to discuss what we could do to take a more pro-active approach to head off emerging misconduct and the most visible outcome of that discussion was the joint policy announcement issued by the Stock Exchange and the SFC on 21 May. That announcement is usually referred to these days as "the suspension policy". But in fact, it goes a lot further. People should read it very carefully. It says, among some revolutionary things, that the Stock Exchange and the SFC will hold people to the announcements they make. If you say that you're not going to engage in a transaction, you're not going to make a placement, you're not going to do a rights issue, you're not engaged in negotiations with a Mainland party, then the chances are very good that you will not get the requisite waivers and the requisite listing permissions for the new shares you need to complete any deal that does emerge, or at least you'll have to give a very good explanation as to why you said one thing and now you're doing another.

But it's the suspension aspect of that policy that I need to administer or help in administering. I've been advised that it's a bit misunderstood and that I should talk about it.

The other thing that very brief announcement said was that from now on the regulators would try to examine movements in the markets very closely. If we saw unusual, unexplained increases in price and volume, the stock would be suspended and would be suspended for as long as it took to work out what was going on. Since that policy was announced, we've suspended about three dozen stocks. Most of those stocks, by the way, stayed suspended for a fortnight or so, and people seem to think that's a long time. Other stocks have been suspended for some months and there are one or two that we are looking at that may be suspended almost indefinitely. That's where there's a particular problem identified in the surveillance process that means that the company has to announce something it does not want to announce or it has to complete a transaction before it can go forward.

The way we work out what to suspend is that we look at a range of criteria. They're all common-sense criteria. We look at the extent of the price movement and pay attention to volume. If you see the price is moving a lot with very low volume, we take no action. One day, we may come back and look at those stocks to see if they are liquid or if they have a proper free public float but we haven't got time to do that now. The other is the relationships to fundamentals. Quite a lot of stocks in Hong Kong have been very very under-valued and it's not unnatural that they should enjoy a re-rating as soon as they're analysed. So, if the P/E is going to the tens to twenties, it's not necessarily grounds for concern. We look at the velocity of the trading. We look at the nature and the source of the buying activity. We're getting pretty good at identifying broking firms who are certainly mixed up in these stocks quite a lot. We look at the historical performance of a stock and then we make a judgment call. Because it's a judgment call we don't always get it right. We're not perfectly consistent. We've examined some stocks we suspended, and found the cause of the move was just a change of market sentiment. We've failed to suspend others which, with the benefit of hindsight, we probably should have suspended. So, it will never be perfect. But the policy will continue.

As a result of that surveillance process, we have instituted, by our standards, a significant number of section 33 investigations. It does cover a significant proportion of the stocks suspended. That means that we're now investigating suspected insider dealing, market manipulation, breaches of the Takeovers Code and other serious offences in relation to those stocks. Stocks that are being investigated include some Mainland-related entities and some Hong Kong entities. The policy is applied uniformly to every sort of company. It will continue to be so applied.

It's far too early to say whether we will be able to establish that misconduct occurred or whether there's an innocent explanation in some cases.

But it's a deliberate object of these investigations that, where there has been suspected misconduct of a serious nature, to extend the scope of our investigation to those who facilitated the conduct, not just the insider dealers or market makers, but to those who stood by and let it occur when they should have taken action that could have prevented it.

At the moment the self-regulatory system needs a degree of reinforcement. Some people are not discharging the responsibilities that they have and we need to make some examples to get the lesson across that there's no competitive advantage from being negligent. So, we are interested in whether a company director should have released information more fully, more fairly and earlier. We remain interested in when a company director should have gone on an inquiry, or at least discussed with the Stock Exchange why there was an unexplained price movement.

In relation to intermediaries, they have a duty to act honestly and fairly, in the best interests of their clients and of the integrity of the market and to use due skill, care and diligence in doing so. Also to know their clients. Sometimes, that might mean they have to advise a retail investor against buying a share. That will be rare. Sometimes, it will mean they have to advise a party against certain transactions.

But it will always mean that they cannot associate themselves with what they suspect might be misconduct. They have a duty to go on enquiry. They have a duty to refuse to act.

I'm not talking here primarily about the broking industry. The message is very largely aimed at the financial advisory industry, the people who act as intermediaries between the listed companies and the Stock Exchange and the SFC. They need to make sure that when they make a representation to us, for whatever reason, it's one they believe on reasonable grounds is true. It's not enough to say that they believed the client. It's not enough to say that they made a mistake. They have a duty of due diligence and duty of good faith toward regulators. It's only a very small minority of the advisers who are taking an advocacy role rather than discharging their responsibility, to bring the interests of the clients and the interests of the market together in a constructive way. That's where the expertise comes in. That's what they get paid for.

This is a message about a very small minority. Because I'm an enforcer, it sounds like a threat. For most of the financial industry in Hong Kong, for most of the directors of listed companies, I hope it's not a threat. I hope it's a reminder that you must be vigilant. You must remember that we are not immortal. You must do what you can to reinforce the self-regulatory part of the system in the interest of the whole of the market and of the long-term development of Hong Kong. I am actually personally very confident that that will happen.

Hong Kong faced a major challenge after 1987. It rose to that challenge of establishing international credibility quickly and well. It now needs to respond to the new challenge of re-establishing credibility at the opening stages of what the world sees as a new market - Hong

Kong as a credible financial centre that holds to international standards. We're hoping to strengthen the self-regulatory system as much as possible. We need the flexibility and adaptability that self-regulation provides. I'm an enforcer but I do not want to see new rules, black letter rules, new laws giving new powers to us. What we want to see is self-regulation to be effective to the degree it traditionally has.

Edgar Cheng

What Does Investor Protection Mean in Hong Kong?

16

1995

In the last few months there has been some debate in the press about investor protection in Hong Kong, particularly protection for small investors and minority investors.

This is a particularly suitable forum for me to express some of my thoughts on this subject.

First, it is necessary to address what is meant by investor protection. This has many aspects. I will briefly review the main ones.

First, there is protection against loss due to financial defaults by market participants. This is perhaps the most fundamental area of investor protection and it tends to be taken for granted when market mechanisms are working effectively, as they are now (but were not as recently as 1987). In this context the key protection is an effective central clearing and settlement system with proper risk management procedures consistently applied. This we now have in CCASS, the central clearing and settlement system, whose establishment was a key milestone in the development of Hong Kong's equity market. To back this up, and to provide protection for investors in securities trading activities outside the exchanges, there are rules about the capital resources which authorized dealers must have. Observance of these is controlled by the Stock Exchange of Hong Kong (Stock Exchange) and the Securities and Futures Commission (SFC) and is currently working well. Beyond this, there exists in the Stock Exchange a well-endowed compensation fund to compensate investors in the event of broker defaults, and a compulsory brokers insurance policy which (among other things) protects investors from loss or theft of securities or cash by Members' staff or agents.

The *second* main area of investor protection is protection against abuse by financial intermediaries (brokers, dealers, investment advisers - dare I say it, the sort of firms whom most of you represent). The main protections in this field are:

- The licensing procedure for brokers, dealers and investment advisers, with its "fit and proper" criteria, administered by the SFC, and by the Stock Exchange in relation to our own members.
- Conduct of business rules, applied by both the SFC and the Stock Exchange, designed to ensure that abusive practices (such as front running and rat trading) are prevented.
- Regular inspections (such as those carried out by the Stock Exchange of our members) to check compliance with financial resources and business conduct rules.
- Disciplinary procedures in the case of rule breaches.

A related protection against abuse by financial intermediaries is the transparency of the trading system. Since the introduction of auto-matching (AMS) by the Stock Exchange in 1993 there is a high level of transparency and objectivity in the pricing and prioritization of orders.

In all these areas, I also think it is fair to claim that Hong Kong's investor protection systems are now working reasonably well.

I now come to the *third* area of investor protection - protection against abuse by other shareholders, particularly controlling shareholders, and by company directors and managements. This is the field around which recent debate has mainly centered and where everything in Hong Kong's garden may not be so lovely. So it is this area I would mainly like to talk about.

One of the reasons this is a perennial theme in Hong Kong is that the shareholding structure of most Hong Kong listed companies is different from that of most listed companies today in markets such as the US or UK - in that Hong Kong listed companies are more often than not controlled by an individual or family who originally built them up. The temptation is obvious for such controllers to use their controlling position, and sometimes their superior knowledge of the prospects of the business, to increase their wealth at the expense of other shareholders. Hong Kong's corporate history has many examples of deals or company restructurings which have had this effect. On the other side, we should not forget that in the case of a majority of Hong Kong listed companies, controllers have generally acted with exemplary fairness.

To some extent, the weakness of smaller shareholders relative to company controllers is a product of Hong Kong's social and business culture and history more generally, particularly a widespread and healthy belief in the principle of *caveat emptor* (Let the Buyer Beware) - the belief that investors are grown up people and should look after their own interests without Nanny (in the form of Government or the Stock Exchange) needing to intervene to bail them out. This prevailing business culture has undoubtedly influenced the development and content of rules, regulations and legislation designed to protect smaller or minority shareholders. In the area of legislation in particular (to which I will return later) there are fewer provisions designed to protect minority shareholders than would be found in most international markets.

But before trying to reach conclusions, I would like to examine briefly what protections do currently exist in Hong Kong. The main relevant instruments are:

- The Listing Rules of the Stock Exchange
- The Companies Ordinance
- The Securities and Futures Commission Ordinance
- The Securities (Disclosure of Interests) Ordinance
- The Securities (Insider Dealing) Ordinance
- The Code on Takeovers and Mergers
- The Code on Share Repurchases

I would like to examine some of these. First the Stock Exchange Listing Rules. As you know, since 1991 the Exchange has had (on a delegated basis from SFC) the role of front-line regulator of listing matters. The Listing Rules are designed primarily to ensure that:

- Applicants are suitable for listing;
- The issue and marketing of securities is conducted in a fair and orderly manner and that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer;
- Investors are kept properly informed by listed companies of factors, developments or transactions which might affect their interests - in particular, that immediate disclosure is made of any information which might materially affect the price of a company's shares;
- All holders of listed securities are treated fairly and equally; and
- Directors of listed companies act in the interest of shareholders as a whole, particularly where public shareholders represent the minority.

Of particular importance in the context of minority shareholder protection are the Notification provisions in Chapter 14 of the Listing Rules which require notification to shareholders of transactions of a certain type or size, and consent from shareholders for certain transactions, notably most 'connected transactions' - i.e. transactions between a company on the one hand and a director, substantial shareholder or chief executive (and any associates) on the other. In such cases there is obviously particular scope for conflicts of interest.

Also important are the financial disclosure provisions of the Listing Rules and the accounting standards attached to these.

As you know, back in 1989 our Listing Rules were re-drafted, based on those of the London Stock Exchange. They have subsequently undergone a series of amendments. I think it is fair to claim that they are fully in line with international standards. Of equal importance to the actual rules is ensuring that they are understood and accepted.

This means "education" of listed companies and other market practitioners (such as merchant banks) in their responsibilities towards investors. I do not wish to make it sound as if the Stock Exchange is "teacher" and the listed company directors are all school boys. Nor do I (*pace* Mr Ermanno Pascutto) advocate examinations (indeed, I understand Mr Pascutto never actually proposed exams either). But there is a great deal the Stock Exchange can do and is doing to influence corporate and market behaviour towards respect for the rules (which is really enlightened self-interest in the long term) and to develop a more investor-protection-conscious culture. Our Listing Division organises regular workshops on corporate governance and investor protection issues. I know the Division has plans to expand these activities.

There is, however, one area where it is arguable that the Exchange needs more backing, which could only come through Government action. This is the area of enforcement. The Listing Rules form the basis only for a contractual agreement between the company and the Stock Exchange. The sanctions which can be applied by the Exchange if the Rules are breached are confined to reprimanding or (in extreme cases) censuring a company or its directors, declaring persons unfit to be directors of a listed company and, as a last resort, suspending or canceling the listing. Reprimand and censure may be effective as a deterrent to some (generally the respectable) members of the community, but the inconvenience they cause to unscrupulous businessmen is unfortunately limited. And reprimanding directors does nothing to compensate investors who have lost money. Suspension or cancellation of listing is often a self-defeating weapon in the context of protecting minority shareholders, since it removes from them the market - the only means they have of getting out. Thus, in the context of enforcement, the Listing Rules by themselves can only go a limited part of the way.

In most other "developed" markets, where the Stock Exchange is the primary regulator of listing matters, there now exists statutory backing for the Exchange's listing rules. Such backing was introduced for the London rules by the UK Financial Services Act of 1986. In other markets, there are provisions in statute which impose obligations on listed companies and their directors which parallel our principal listing rules, breaches of which carry statutory penalties and/or an obligation to compensate investors. I do believe the time has come where Hong Kong should seriously consider whether we need something similar in our own legislation. I would like to put this idea up for serious public discussion. If we do introduce legislation in this area, I believe it should be simple and limited in scope to providing a few statutory "teeth" to support the Listing Rules. This would not in any way reduce the role of the Stock Exchange. Indeed, it should reinforce that role. Nor do I believe it would be any inconvenience to the vast majority of company directors, to whom correct behaviour is a matter of course. It should, however, influence the behaviour of the small minority who are tempted to flout the rules. If such statutory obligations for listed company directors are introduced, they should be applied pragmatically and accompanied by informational programmes run by the Stock Exchange or SFC, designed to make sure that such directors are fully aware of their obligations.

Apart from the Listing Rules, what other protections for smaller investors are there? The Companies Ordinance contains important provisions concerning fraud and misfeasance by directors, but this piece of legislation is a framework for company formation and control in general and does not attempt to deal with the particular requirements relevant to listed companies. Company law and securities law are different things. Moreover, something like half the listed companies in Hong Kong are incorporated outside the territory, and are thus not in any case subject to many of the provisions of the Companies Ordinance.

The SFC Ordinance and Securities Ordinance are relevant in that they give to the SFC certain powers of investigation. However, these are basically confined to matters related to dealings in securities, rather than the behaviour of company controllers or managers. If there is a *prima facie* case of fraud, the SFC or the Government may intervene, but oppression of minorities does not fall into this category.

The Securities (Disclosure of Interests) Ordinance (commonly referred to as the SDI Ordinance), addresses disclosure of shareholdings of directors, chief executives and their associates and of other so-called "substantial shareholders" with holdings above a certain size, and increases or decreases in such shareholdings. It is a complex and rather turgid piece of legislation and the disclosure threshold (10%) for substantial shareholders is too high to be meaningful in many situations. I understand consideration is being given to lowering this. In the UK the threshold is 3%. However, as regards disclosure of share transactions by directors and others, the SDI Ordinance has been quite successful - and a number of disciplinary actions have been taken by the Exchange and the SFC stemming from SDI disclosures or (perhaps more accurately) non-disclosures. Incidentally, the application of the SDI Ordinance, when it was first introduced, was a good example of what I call "pragmatic" application of a statute. Attention was given to education, and for an initial period the provisions were applied leniently while the market adapted to the new provisions. A similar approach should be applied if Hong Kong decides to adopt any new statutory obligations for listed company directors.

The Insider Dealing Ordinance was introduced in 1990. It was based on an earlier piece of legislation specially designed for Hong Kong which also operated through a specially-established Tribunal. Prior to 1990, the strongest sanction for insider dealing was public censure. Now, the penalties include fines of up to three times the profit illicitly made or the loss avoided. The Tribunal is by nature a somewhat unwieldy instrument and the number of cases it has handled (or could handle at once) is very limited.

Tackling insider trading is notoriously difficult in any market and provides enough debating material for a speech by itself. In most international markets it is now a criminal offence. This has not meant that insider dealers have been caught or successfully prosecuted in many cases. Leading international opinion is, I think, trending now in favour of strong civil penalties as being the most effective sanction, sometimes together with a right of legal action against the insider for those disadvantaged by his trading. Hong Kong not only has no criminal penalties, but the civil penalties which exist are "softer" than those in almost any other market which seeks to call itself international. I believe this is a matter which deserves to be considered again by Government in the light of experience in the last few years and international developments.

Another important instrument in the context of maintaining equal treatment between shareholders is the Takeover Code. Hong Kong's Takeover Code is modelled on the UK Code and is administered by the SFC. It applies also to many corporate restructurings which may not strictly speaking be takeovers or mergers. In many cases covered by the Code, issues of fair treatment for minorities also arise. Like the UK Code, it is "voluntary" (i.e. it lacks statutory backing), and the ultimate sanction against a party who flouts the Code is public censure or the so-called "cold shoulder" rule (requiring merchant bankers or other professional advisers not to assist the party concerned in future). The effectiveness of these sanctions in a UK context is greater than in Hong Kong. In most other jurisdictions, takeover matters are governed by legislation. Thus, in this area also, Hong Kong is at the "soft" end of the international regulatory spectrum. Although the Code has worked (in my view) surprisingly well in recent years, I believe the time has come when Hong Kong should perhaps consider a simple provision giving the Code at least some statutory backing in the enforcement context. At present the Code has no real teeth when faced with an abuser of minorities who does not care about his reputation in Hong Kong and will not need the future support of Hong Kong's professional advisers.

What other provisions exist in Hong Kong to help smaller shareholders? I would like to mention the Model Code for securities dealings maintained by the Stock Exchange which lays down minimum standards of good practice for directors of listed companies in relation to their personal dealings. Also important are the provisions of the

Listing Rules concerning corporate governance - in particular the requirement to have at least two independent non-executive directors. Such directors can act to some extent as a watchdog over company managements or controllers; at least they can play a key role in relation to connected transactions.

The quality and timeliness of financial disclosure is of course one of the most vital weapons in protecting against abuse of investors. This was one of the areas of particular focus when the special listing framework for "H" shares was developed. So far, the rules in this field have worked better than I think many people expected. But, whether the listed company is based in PRC, Bermuda or Hong Kong, the effectiveness of the enforcement measures available remains an issue.

So, what more can be done to improve the investor protection framework in Hong Kong? One suggestion made by Mr Anthony Neoh was that institutional fund managers (including no doubt, many of the firms you represent) should adopt a more pro-active stance on behalf of small investors generally. I support this. But I do not see it as more than a very small part of what is needed. Institutional shareholders in Hong Kong do not (even collectively) hold anything like the percentage of most Hong Kong listed companies that their counterparts in the UK would own. And it remains a sad fact that retail investors in Hong Kong (as in many other places) generally do not consider it worth devoting time and money to fighting for their rights in cases where they feel abused. Part of the reason for this may well be the absence of statutory provisions which would give minority shareholders (whether institutional or retail) a basis for pursuing legal action against company managers or controllers. At present, the most they can generally do is try to mobilise public opinion, or rely on the regulators (whose powers, as I have already noted, are also limited). The efficacy of public opinion in Hong Kong against individuals with large and entrenched financial interests at stake has to be questioned.

I therefore believe that the time has come when we should consider whether some basic new legislative provisions are required. I do not think they would need to be extensive or complicated.

Anything we introduce certainly should *not* be modelled on US legislation, which is voluminous and onerous, and has inevitably generated more litigation than is healthy. The issue, I believe, is whether Hong Kong should introduce one or two basic statutory obligations for directors of listed companies, such as an obligation to make disclosure of facts or events which are clearly material to the value of the company's shares, and to give a true and fair picture in all such public announcements. If we decide from a policy point of view that such provisions are appropriate, the opportunity could be taken to include them in the rationalization of securities legislation which is, I believe, due to emerge from the SFC or Government before too long. As I mentioned before, any such provisions should be applied flexibly and pragmatically, and should be accompanied by a special "educational" programme for both directors and investors.

I am, of course, all too well aware of the problems associated with enacting new legislation at this time. Comments have been made by some regulators that politically it is difficult to get the law changed. But it is also difficult to accept that Hong Kong should remain motionless in an area which is important to our credibility as a mature financial centre. I think it is widely accepted that several aspects of our securities legislation need to catch up with the growth which has taken place in our market and the more sophisticated and international environment in which we are now operating. I believe it is in the interests of China as well as Hong Kong that this issue should be addressed.

Governments have many preoccupations, particularly in Hong Kong at this time. The old principle that you do not mend something until it has broken down is always a powerful force in favour of leaving things as they are. Nor could I claim that the legislative weaknesses I have mentioned in our investor protection framework are of such a nature as to lead to sudden and dramatic collapse of the market. But the effect of not addressing these issues could over time become a debilitating factor in the international competitiveness of our securities market.

While suggesting that these matters should be considered, I would still like to reaffirm my general belief that Hong Kong is right in its philosophy that regulation should be kept to the minimum which is really necessary to preserve the status and development of our market, and above all that the rules should be kept simple. I am as sensitive as anyone else in the business community to the dangers of over-regulation. But I do believe that, where we have regulations, they should be capable of effective enforcement. And I believe we should not deceive ourselves into thinking we have effective regulation just because we have the rules. They need to be backed up by the knowledge that if they are flouted, life could be seriously unpleasant for the flouter. This is the area in which I would like to see a serious review by Government of whether some legislative changes should, despite the possible difficulties, be introduced.

Edgar Cheng

17 Does Hong Kong Need a Second Board?

The Hong Kong Venture Capital Association Limited
23 January 1997

I am grateful for this opportunity to address a highly relevant audience on a topical subject: whether the Stock Exchange of Hong Kong should have a Second Board.

By a Second Board, I mean a separate market from the existing (or "Main") Board of the Exchange, specially for smaller, often faster-growing and more "entrepreneurial", companies that have difficulty meeting the full listing requirements of the Main Board.

I propose to review briefly the history of the debate about this question in Hong Kong, to look at the experience of Second Boards in overseas markets, to suggest possible models that could be adopted in Hong Kong and to identify the main considerations which we would need to bear in mind.

History of the Second Board Question in Hong Kong

The idea of setting up a Second Board in Hong Kong is far from new. Shortly after Unification in 1986 of the four previous Stock Exchanges, a working party was commissioned and a report was sent to Government in 1987 recommending the establishment of a "Second Market for Securities". The proposal was modelled on London's then Unlisted Securities Market (USM). Companies would be admitted to the market rather than listed on it. Thus, issuers would not have to prepare a full prospectus but they would have continuing obligations.

The Exchange's existing trading system would be used, with surveillance aimed at preventing market manipulation.

The October 1987 stock market crash occurred shortly after this report was submitted. Attention became focused on the much more fundamental reforms needed to get the main market back on its feet and to repair the damage to the reputation of Hong Kong's regulatory regime. The 1988 report of the Review Committee, chaired by Ian Davison, did touch on the idea of a second board, but found market opinion divided and expressed concern that such a board could become a "second rate" market with poor quality stocks and low standards of disclosure and surveillance. Despite this, another Advisory Group was commissioned in 1990 and supported in principle the establishment of a board for young and growing companies (with a two-year track record, versus the five years then required by the Main Board). However concern was expressed about the likely costs of listing as a proportion of the capital to be raised; further study was proposed to recommend how costs could be cut. Events then overtook the initiative when the Main Board listing rules were extensively revised (the track record requirement being reduced to three years) and the resources of the Exchange became devoted to the higher priority of developing what became the "H" share market for Mainland enterprises.

In 1994, in preparing its strategic plan (entitled The Way Forward), the Exchange conducted a public consultation exercise in the course of which the idea of a Second Board was floated again. The response from practitioners was, frankly, quite lukewarm. This lack of enthusiasm reflected partly, I think, concerns at the time about the quality of a number of third line stocks which had been admitted to the Main Board. However, the Strategic Plan, when it was finally published in early 1995 (just after I became Chairman), did contain a commitment to "review again the desirability and potential market demand for a second board or "Growth Market" for smaller companies with growth potential."

Tentative proposals for a Second Board were again circulated to market practitioners in July 1995 and again drew a response which would have to be described, at best, as mixed. Certainly it was not felt by the Executive of the Exchange that the market reaction justified giving a high priority to the proposal. However, the concept was kept alive by being included in the brief of the New Market Working Group formed in June 1996, and that is where it presently rests. So far the Working Group has devoted its time to considering mainly the potential for a secondary market trading facility for regional stocks and financial instruments (a different but related idea which is receiving serious attention). However the Secondary Market Survey conducted by the Exchange last year raised again the question of a Second Board and elicited a somewhat more positive response - 42% of the Exchange members, fund managers and custodian banks surveyed supported the idea, though 25% of fund managers still disagreed.

More recently I have received letters from several organisations, including the Federation of Hong Kong Industries, the Hong Kong members of the APEC Business Advisory Council, and the Small and Medium Enterprises Committee, suggesting that some form of special market for small and growing companies should be considered; one suggestion was that this should be modelled on the US NASDAQ.

Thus, despite several initiatives over the past 10 years, based on somewhat varying "Second Board" concepts, we still do not have such a Board and the views of market practitioners still seem to be divided on the desirability of establishing one. However, I believe the time has come where the Exchange should finally either drop the idea or decide to go ahead with it despite the real risk that the new market could fail. And the issue is not only whether we should have a second board but, if we do, what form it should take - what should differentiate it from the Main Board in terms of rules and regulations and what kind of companies it should seek to cater specially for?

Overseas Experience of Second Boards

To have an informed discussion of these issues, we should obviously take a look at experience in other markets. As a generalisation, the majority of developed overseas stock markets do have more than one listing venue. Within Asia, Singapore's SESDAQ and Kuala Lumpur's Second Board have performed rather well over the last year or two. London's USM was closed down in 1996 but replaced shortly thereafter with the Alternative Investment Market (AIM). This seems to have got off to good start, as has Paris's Nouveau Marché.

Overseas alternative listing venues are of different types. In some cases, the exchange's Main Board is divided into sections for different types of companies. Examples of this are Thailand and Taiwan. In both Singapore and Kuala Lumpur there is a Second Board with different quantitative requirements for listing but it is managed by mainly the same exchange personnel and under similar rules and culture to the main board.

London's AIM is a different model. The UK's former second board (the USM) was run in a similar manner to the main board, being distinguished by its lower listing requirements. When the track record requirements for a main board listing were reduced, the USM declined in importance. When AIM was conceived, every effort was therefore made to develop for it a distinct culture and role. AIM was set up as a subsidiary of the Exchange with its own Chief Executive, its own order-driven trading system (in contrast to the then quote-driven main board), simplified and low-cost rules and nominated advisers to help issuers with compliance and support in post-IPO trading. AIM has now been functioning for just over a year. It has over 200 listings, with a market capitalisation of over US$5 billion and a total turnover in the past year of approximately US$1.6 billion. This is generally considered a very successful start, even allowing for the fact that AIM inherited some USM listings and benefited from some technical measures such as the abolition of former section 4.2 listings on the main exchange.

France has also adopted the approach of a separate market with its own management structure and systems. The Nouveau Marché, launched in 1996, now has 12 listings and a market capitalisation of US$850 million.

The most successful market in the world for smaller or growth companies is undoubtedly NASDAQ in the US, although this could hardly be described as a second board. It was launched in 1971 and now has a market capitalisation of US$1.4 trillion. Daily average turnover, at $12 billion, approaches that of the New York Stock Exchange. NASDAQ is not just a place for smaller companies to list until they qualify for New York's Big Board. It has become a large and rival market. Several major US companies such as Microsoft, as well as international issuers such as Reuters and Volvo, have kept their listings on Nasdaq, although they could easily obtain a New York listing if they chose to.

In Japan there is also a separate market in the form of the OTC Exchange which has enjoyed considerable success in recent years. It has a market capitalisation of $125 billion, 780 listed companies and an average turnover in 1996 of $230 million per day; there were 114 new listings in 1996.

Based on this quick review of overseas experience, I would suggest that there are two possible models for Hong Kong, from the point of view of market structure:

- First, there is the true "Second Board" model - a board with lower and simpler requirements than our existing main board, but otherwise managed in a similar way by the same people, and using our existing (order-driven) trading system. This was the model proposed by the Exchange Working Groups in 1987 and 1990. Its obvious advantage is that it would be a low cost option, requiring relatively little investment to implement.
- Second, there is the separate market model, best exemplified perhaps by London's AIM. This would be separately managed, though still under the control of the Exchange Council. It would have its own CEO and staff, its own marketing function and possibly a different trading mechanism. It would not be a "nursery" for the main board, though transfer from it would be possible. There might be some special ongoing role for the sponsor to the issue.

The second of these approaches is clearly the bolder one. It would involve a significant investment in people and technology which would probably not be recovered for a long time. If the full cost were imposed on users of the new market, it might never take off. The only way of mitigating the cost would appear to be some form of subsidy (such as was in practice given to AIM). If successful, such a new market would probably affect, and might even offer some competition to, the Main Board (I do not, incidentally, regard this as necessarily a bad thing). It would certainly open a new dimension for the Hong Kong capital market.

Issues in the Hong Kong Context

Let me now try to address some of the more particular issues which arise in the Hong Kong context when considering a Second Board.

The first is: what focus should such a board have? What kind of issuers should it aim to attract? One possibility is "high-tech" stocks. I have heard concerns about the decline in Hong Kong's industrial base, coupled with calls for fresh initiatives to develop high-tech industry here, in the way that Singapore has done. I have also heard suggestions that we should concentrate more on encouraging the development of small service industry firms. An obvious target for a second board would be potentially high-growth Mainland-based companies (or Hong Kong companies whose business is on the Mainland), including joint ventures. This could require some quite special rules to cater for circumstances on the Mainland. There is now a substantial volume of money in private equity funds managed from Hong Kong investing in unlisted Mainland companies. A second board in Hong Kong might provide an attractive potential exit for such investors. Another possible focus for second board listings would be companies in the S.E. Asian region who do not have a market at home (e.g. Vietnam or Myanmar), or who have a regional focus, or who are looking for an alternative to their domestic market.

The second issue is regulatory philosophy. This is perhaps the most tricky aspect, and the one which has aroused greatest concern in previous public consultation exercises. By definition, companies listed on a second board will tend to be smaller and riskier than Main Board companies, and they will generally have less resources available for ensuring regulatory compliance. The risk of market manipulation and insider trading is also higher. Even in relation to third-tier stocks on our Main Board, this is seen to be a problem. The concern is that a second board could turn into a casino, with the result that it fails and damages the reputation of the Exchange in the process.

It has to be admitted that this is a difficult concern to dispel. Hong Kong's listing regime does rely quite heavily on self-regulation and on the integrity of listed company managements. There are no statutory penalties for breaches of the listing rules. The enforcement measures available to the regulators are considerably less extensive than in the more mature markets which have second boards. There is thus a real risk that a second board could attract unscrupulous operators. The question is: how could we deal with this? It is theoretically possible to conceive of a second board with lower listing qualifications but a tougher enforcement regime. But I do not see how this could work in practice. I think we just have to take a view as to how likely it is that a second board could degenerate in this way, and weigh this against the extent of the need for such a new market in Hong Kong. Some additional health warnings could be attached to the second board, to try to ensure that investors were made aware of the higher risk involved. It would be vital that there were no misconceptions among investors about the responsibility carried by the SEHK in relation to the behaviour of companies listed in any second board.

One possible alternative would be to go quite consciously to the extreme of having a pure "*caveat emptor*" second market - i.e. the Exchange would not pretend to provide more than a rudimentary regulatory function, and would confine itself to providing a trading facility for such stocks. It would then be left entirely to the market to assess or discover which companies were incompetently managed or run by crooks. There is a case for this approach, provided the nature of such a market is properly understood and accepted by investors. However, it would be a major departure from the way we operate our main market. And we would need to assess very carefully the potential impact on the reputation of the Exchange, however many health warnings we hung over the door.

The third issue I see is whether any second board should have a different trading mechanism from the Main Board. We have in the past considered the introduction of market makers for smaller stocks or a single-price auction system such as that which is used in some emerging markets. We concluded that this would not be right for our Main Board. However, the answer in relation to a Second Board might well be different. Making a market for a given period of time might also be made one of the obligations of the sponsor of second board issues.

A fourth issue to consider is whether the establishment of a second board should be accompanied by any restructuring of our existing Main Board. Our present "one-size-fits-all" system already encompasses an unusually wide spectrum of companies in terms of size, experience and quality.

Finally, there is the very important question of costs. A second board, by definition, will contribute only a small amount of additional trading, at least in the initial years. The additional costs of a second board for our Exchange could be considerable, especially if a disproportionate amount of regulatory resources has to be directed at it. A second board run on a purely commercial basis would almost certainly not be viable; the costs of issuing would be prohibitive for potential listing candidates. Therefore, if we were to get a second board off the ground in Hong Kong, we would certainly have to subsidise it for a number of years from the other revenues of the SEHK. I do not suggest this is necessarily inappropriate. If there is a genuine market need for a second board, and if the regulatory risks I mentioned can be accepted, then the Exchange should in my view be willing to bear the cost aspect, provided it is not out of all proportion to the benefits.

PART VI

TECHNOLOGY, MARKETS AND GOVERNANCE

Andrew Sheng became Chairman of the Securities and Futures Commission (SFC) in October 1998. In his maiden speech, "Hong Kong and Global Markets: Back to Basics", Andrew Sheng pointed out the need for Hong Kong to adopt the highest international standards of accounting, law, transparency, accountability and business conduct. In the second speech, when Hong Kong faced the "Tech Bubble", he examined the New Economy and what it means for fundamentals, technology, markets and investors. The third speech provided insights into how the SFC will implement the composite Securities and Futures Bill. Finally, he examined the theoretical and practical aspects of regulation that make financial regulation a craft and not a science.

Then Deputy Chairman Laura Cha, one of the prime stewards of the merger of the exchanges, discussed the regulatory framework and Hong Kong's three-pronged reform of the securities market. Executive Director Mark Dickens discussed the implications of e-commerce in widening the scope of regulation, in enhancing investor protection and market integrity, and in reducing systemic stability without imposing undue burdens on industry. Then Executive Director Paul Bailey shared the SFC's philosophy of enforcement: the what, why, how and principles of enforcement.

This Part includes a speech by Charles Lee, Chairman of HKEx, on "The Outlook for Exchanges in the 21st Century". Dr Edgar Cheng, former Chairman of the Stock Exchange of Hong Kong, who first floated the need for the merger of the exchanges, shares his unpublished paper, "China's Horse in a Global Race - Positioning the Hong Kong Securities Market". In his speech, then Hong Kong Futures Exchange Chairman Geoffrey Yeh, pointed out the role played by the Exchange in the management of risk.

ANDREW SHENG

18 Hong Kong and Global Markets: Back to Basics

Hong Kong General Chamber of Commerce
26 October 1998

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.

Andrew Sheng

New Economy - Old Fundamentals Technology, Investors, and the Market

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Hong Kong Securities Institute
15 March 2000

First of all, I wish to explain that as a financial regulator, it is not my role to explain how, what and when to invest - that is the job of investment advisers. Indeed, by definition, the regulator knows less than the market about which stocks are winners and which losers, or about forecasting index levels. No less an authority than Alan Greenspan, when he spoke of "irrational exuberance" having "unduly escalated asset values", in February 1997, could have foreseen the Dow rising another 40% and the NASDAQ Composite nearly tripling to recent levels.

But it is my job as the regulator to give health warnings, to help explain the risks, and to point to potential issues.

Recently, the Hong Kong market reached record levels, and many investors must have made lots of money. Some may have forgotten that barely 18 months ago, the Hang Seng Index (HSI) saw record lows. Less than 30 months ago, we had a fever in Red Chips. Perhaps market movements in these few days are a good reminder to us all. The faster the market rises, the higher the risks.

This time round, it is High-tech Chips that everyone is excited about. Although I have made the same risk warnings, many small investors have rightly asked me how have tech stocks changed the way the market behaves? Are they wrong in chasing tech stocks? Is it wrong to chase high-tech stock numbers 5354 or 8589 (I wish to stress that there are no such listed companies with these numbers) when the small investor has great difficulty understanding what technology is all about? I then realized that we have a huge investor education programme on our hands. This is what this lecture is all about. When you buy or recommend a company's shares, do you know what you are buying or recommending your client to buy?

There is no doubt in my mind that technology is transforming our lives, and the securities market, in ways that no one can predict with any certainty. It has unleashed a potent combination of demand for capital by entrepreneurs of the New Economy, and a large supply of investors wishing to participate in this social and economic revolution. Technology has outstripped the capacity of many societies, including the regulatory framework to cope with this rapid change. With more complex technology and knowledge, come greater opportunities as well as higher risks. Market professionals, investors, the Stock Exchange, and the regulator - that is, all of us - should take a hard look at the profound changes, so that we do not just focus on the good times, and forget to plan for what is around the corner.

By the third quarter of this year, when the new electronic trading system of the Stock Exchange AMS3 goes live, online trading in Hong Kong will be a reality. Once NASDAQ shares can be quoted in Hong Kong and further alliances with other regional and international exchanges are entered into, it is likely that an investor in Hong Kong will be able to buy and sell Hong Kong and global securities via their computer, mobile phone, or WebTV at home. Since even betting on the Hong Kong Jockey Club can soon be via the Web, it would not be untrue to say that potentially, we could have a 24-hour investing or gambling machine in every home via the Web.

The Securities and Futures Commission (SFC) as a market regulator should not stand in the way of growth. Indeed, we have tried to facilitate positive development wherever we could. There is no denial, however, that there are new risks. Hence the regulator has to walk a tight rope between facilitating change and investor protection.

In the area of technology, the speed of change is so fast and bewildering that, although most people are aware something important is happening, we have difficulty understanding the full implications. Consequently, it is quite rational for many investors to wish to participate in this New Economy in any way they could. This wave of interest has created the current "tech fever" which is sweeping the US, Europe, Japan and now Hong Kong.

Hong Kong is not alone in facing these challenges and risks. The same concerns have arisen in other developed and emerging markets. The Technical Committee of the International Organization of Securities Commissions (IOSCO), which includes representatives of the securities regulators of all the world's major markets, has agreed to work together on an urgent basis to compare notes and to reach agreement on how to respond to the risks that we all perceive.

I recently went to the US to try to catch up on trends there. We at the SFC try to exchange experience and approaches with our fellow regulators and market participants internationally. I think it would be useful to share with you some of my personal views on what has happened so far in the securities market, and what implications the New Economy will have for investors, issuers, market intermediaries, exchanges and regulators.

The New Economy

Speaking as a former central banker, the recent rise in stock markets has both macro and micro origins. At the *macro* level, the world is awash with liquidity, ironically partly because of the Asian crisis, which caused a monetary easing in 1997-98 to prevent a global meltdown. Secondly, an aging population in OECD markets has increased investor interest in equities for their retirement savings. Thirdly, financial deregulation and innovation has created greater investor choice, improved intermediation and made markets more efficient and global. Fourthly, companies have become more efficient in the 1990s through greater competition, consolidation and merger, as privatization and technology have driven change.

But there is no doubt in my mind that technology has become a major driver of change. The Silicon Valley has been described as "the greatest legal creation of wealth in the history of the planet". Through changes in telecommunications, media and the Internet, and changes in capital-raising capabilities via venture capital and markets such as NASDAQ, entrepreneurs are now able to tap increasing resources for new ideas and new investments in technology. At no time in history have the financial markets been so friendly to small entrepreneurs with big ideas.

Currently, Hong Kong legislation will not allow small companies to raise capital from the public without the publication of a prospectus and a formal initial public offering (IPO) process. But technically speaking, some US companies have already gone direct to investors through the Web to raise their capital. What risks do these hold for both the investor and the issuer, if the traditional intermediaries, the stockbroker and the exchanges are cut out from the loop?

On the demand side, one worldwide trend is that technology is leveling the playing field for the small investor, giving him or her access to information previously available only to the specialist or the professional. The Internet has also enabled just about anyone to become an online trader. Add to these two factors increasing globalization, we can see that a small investor today has access as well as easy tools to trade in markets and financial products that the traditional investor never dreamt he or she could buy and sell.

Online trading has caught on rapidly in the US, accounting for nearly one quarter of trading on NASDAQ. But, who could have dreamt that Korean online trading, almost non-existent two years ago, could be almost as large as that of the US? Once Japanese, European and other Asian investors catch on, the global securities market will be a reality, not a dream.

What is happening, in essence, is that technology is empowering the masses. And we are only at the beginning. I am not sure where this development would lead us, but I am certain the process to get there will have many new challenges.

One potential challenge stems from the fact that supply of shares in each IPO is usually very limited, while retail investors naturally want to have a piece of the action. A number of other regulators and market thinkers have related to me what they see as happening. The combination of limited supply and aggressive demand means share prices go up. Mix in an element of momentum trading and you get an explosion. As one Silicon Valley analyst said, "Dreams and greed were a potent combination".[1] As is the experience in other markets, initially it is the professional investors and retail day-traders who trade these high-risk stocks.

But when a company's market cap grows large enough, it gets included in an index. Then institutional investors start buying, many because they are required by law or by their own policies. In fact, traditional value-investing fund managers are being "punished" by the market for their low performance relative to these high fliers. Thus, when the prudent institutional investors and the high-risk day-traders both chase limited supply of high-tech stocks, this sends share prices to stratospheric levels. I am not sure how to go about proving or disproving this theory. We are raising it with people and trying to learn more. Obviously if it is true, there is some very explosive thermal dynamics going on. What goes straight up can come straight down. The last investor holds the losses.

A second worldwide trend, going hand-in-hand with the increasing impact of retail investors, is the increasing number of technology companies raising money in the securities market. This to some extent just reflects the fact that there are a lot of tech companies around. But tech stocks do often differ from traditional listings in some respects.

[1] David A Kaplan, "The Silicon Boys and their Valley of Dreams", 1999.

First, many technology companies come to the market much earlier than traditional companies and even before they have any record of earnings. This throws all existing pricing models out the window.

Second, technology itself is changing so fast that it is hard for anyone to judge whether a tech company will be the next Microsoft or the next bankruptcy. Statistics so far indicate that many tech companies do not make it. In the US, 75+% of venture capital investments fail, while roughly only one in 10 make money for their investors. In a sample of 1999 IPOs, 83% had negative earnings, but still witnessed price increases.[2]

Obviously as a regulator I cannot comment on the valuation of individual stocks, but it might be useful to sum up the current state of the market and quote a few facts and market comments on the subject of tech stocks:

- Current US P/E ratios are already well above the prior historical peak in September 1929;
- Japanese TMT (technology, media and telecommunications) market cap, mostly not included in the traditional index, is now 90% of the traditional Nikkei 225 market cap;
- The current rally in HSI, driven by interest in tech and telecom stocks, is already higher and faster than the previous boom with Red Chips in 1997 (Chart 1);[3]
- Out of 1,200 tech US IPOs over 18 years since the debut of the PC, 66 stocks or roughly 5% of the total are up 1,000+%, and have created 86% of the wealth;
- Analysis of IPOs in Hong Kong between 1992 and 1998 indicates that following first day's trading, the heavily oversubscribed stocks tend to under-perform the Hang Seng Index over a one-year period (Chart 2).[4]

[2] Steve Galbraith, Bernstein Research, March 14, 2000.
[3] Source: Bloomberg.
[4] Source: Morgan Stanley Dean Witter.

Markets move in cycles with the ebb and flow of supply and demand. New companies arrive with new technology and sometimes supplant old companies that cannot compete in the new environment. This time round the transition is faster and more turbulent, because of the new forces of supply and demand that technology has unleashed. But we can be certain one thing always remains unchanged - the market demands that eventually a company makes money. Sometimes, companies can delay making profits (and run short-term losses) if it delivers high growth in revenue, but ultimately it must deliver net earnings. As one seasoned Internet investor said, "I've gotten used to buying companies without earnings. I am not yet to the point of buying companies without revenues." If the market trusts that the company will eventually make money, the share price will rise, but the market is depending on trust. Confidence and trust are ultimately the bedrock of all markets, even for high-tech markets.

Role of Investors

Investors should remember that for companies without earnings and without track records, they are buying into concepts. Concepts are described in plans with words. If they have any physical existence, their value usually rests in intangible things such as entrepreneurship, good management and positive forecasts. They often are not embodied in tangible assets or operating businesses.

In other words, investors are placing their trust in concept stocks, essentially in promises and predictions. Each investor in a high-tech company owes a duty to himself or herself to understand what he or she is really investing in. US Securities and Exchange Commission (SEC) Chairman Arthur Levitt calls this "investing with your eyes open".[5]

[5] Arthur Levitt, "Investing with Your Eyes Open", Los Angeles Times 4th Annual Investment Strategies Conference, 12 February 2000.

Will management deliver the promises of earnings growth? Management must ultimately deliver earnings. They cannot forever deliver concepts.

Moreover, just because an existing company adds "dot com" behind their name does not mean that it can become a high-tech growth miracle overnight.

Investors should also understand that increased availability of information has also led to information overload, information hype and misinformation. According to one observer, "On the Internet, any firm can look enormous, research can sound credible, individuals can seem qualified, all without any real foundation".[6] In short, "in cyberspace, it is easy to be larger than life". No wonder that many US Internet companies spend a fortune in advertising and hype.

Some analysts suggest that you need to ask several simple questions when investing in a high-tech company:

- Where is their market and are they focused in their business?
- Can they make profits from this business? What are their margins?
- Do they have proprietary technology - in other words, can someone duplicate their technology easily and take away their business?
- Will they get paid? Everyone wants to use the Web, but so far few people pay for these services.
- Do they have strong and reputable management?
- Are they backed by the right groups, such as venture capitalists with track records?

Basically, what I am saying is that an investor must at least understand what he or she is getting into - "know what you are buying". No one is trying to stop an investor wanting to get rich by investing in concept stocks or following IPOs. These carry high risks. Remember that if you might get rich quick, you could also lose quickly.

[6] Barbara Perrier-Dreyer, in Technology Roundtable, US SEC, April, 1998.

A prudent investor must manage his or her risks. In horse racing, no one begrudges an adult from punting his pocket money at the Hong Kong Jockey Club. But everyone would feel very sad if the same person bets away his housekeeping money, or savings for his children's education or his retirement. The same must hold true for the average investor. You should understand exactly how much you are prepared to allocate in concept stocks. Don't blame anyone else for losses, if you follow stock tips blindly or just chase a number.

Moreover, buying on margin may look easy, but leverage increases risks considerably. You are betting your future on borrowed money. As Chairman Levitt says: if you use borrowed money, you may double your money, but you can also double your losses. If you are in doubt on what to do, seek the advice of a qualified investment advisor. There is also an increasing number of investor education programmes available on the Web.

However, investor education has tended to focus on the buy side. There is a need to think through the sell side too. The converse of "know what you are buying" is "know what you are holding and when to get out". Investors should keep a close eye on companies' efforts at turning concepts into businesses and delivering on their promises. If you are uncomfortable, you could vote with your feet. Perhaps old wisdom contains the simplest truths. "It never hurts to take profits and diversify". And "greed is the most common source of downfalls".

Role of Issuers

We noted earlier that investors are placing their trust in the issuers' promises and predictions that their business plans would eventually bring profits.

Issuers should take this trust seriously. They are able to raise capital because investors believe in their creativity, diligence, and business acumen. For those who have good track record, their reputation is at stake. All their skills should be applied to materializing concepts and delivering on promises. Many have also been rewarded with share option schemes to induce performance.

My father used to say that there are three ways of making money. The first way is through blood, sweat and tears. Most small entrepreneurs make it this old-fashioned way. When you reach a certain stage of success, money makes money. Finally, your name makes money. Since many small investors cannot distinguish one technology from the other, it is not surprising that they go for those with good names and reputation.

What I am saying is that for the issuers, raising public money carries public responsibilities. If things do not work out despite a lot of honest, hard work, then no one could be blamed. But if the controlling shareholders and management abuse the trust placed on them, misuse the capital given to them to turn concepts into real businesses and instead divert or squander it for private benefit, then they have wronged their investors. This will not be tolerated.

The public and the regulatory authorities should be vigilant against potential fraud and manipulative behaviour. On our part, we will do our best to work with the Hong Kong Exchanges and Clearing Limited (HKEx), the Commercial Crime Bureau of the Police, and if needs be international regulatory bodies, to minimize financial fraud and crime.

Incidentally, the fact that investors have placed their trust on the issuers implies more than requirement of faithful efforts to materialize concepts and deliver on promises. It also implies an obligation to keep investors informed. The main objective of financial reporting is to provide reliable, decision-useful and timely information to shareholders and prospective shareholders so that they have a sound basis for investment decisions.

To strengthen the sanctions against false or misleading information, there is now a Bill before the Legislative Council (LegCo) that creates offences for anyone who provides the SFC and the recognized exchanges and clearing houses false or misleading information. The Composite Bill, which will be published for public consultation next month and is expected to be put into LegCo before the end of the year, will contain a number of provisions aimed at strengthening corporate disclosure. Our legal framework has to ensure that issuers and management do not provide bad or misleading information.

Role of Intermediaries and Market Professionals

Intermediaries and market professionals are part of the trust relationship too. They do not just intermediate transactions of money and securities. They also disseminate information as well as provide outside checks on issuers and management.

Intermediaries obviously have a major role, providing financial advice as well as a lot of market and other information. Investment bankers and securities houses make recommendations on investments. Independent auditors express their opinion on the true and fair view of financial statements, which are essentially objective assessments of the state of play in materializing concepts and delivering promises. Lawyers perform due diligence on the veracity of statements in public issue and other documents. Professional appraisers provide an outside opinion on valuation of assets. Responsible investment advisers and brokers explain to their customers what risks their clients are entering into.

As I indicated earlier, concept stocks raise particular problems in valuation. They raise difficulties for accountants who may have to express an opinion on the business plans of companies. I earlier mentioned use of options as incentives for management performance. But as US Federal Reserve Vice Chairman Roger Ferguson has observed, in many cases options are not being recorded as compensation at the time they are granted. They estimate that the value of these options would translate into a 10 percent reduction in the income of S&P 1500 companies. This vividly shows how important accounting treatment is as a measure of economic value.

The SFC has noted on some occasions where valuations seem inflated. It has therefore asked the issuer to ask their valuation experts to disclose the basis for valuation, so that the public can judge for themselves whether these methodologies are credible. The SFC is now working with the Hong Kong Society of Accountants' Financial Accounting Standards Committee to examine the basis for valuation of interests in high-tech companies. These are important work in progress.

Because of the expertise of market professionals, investors place their trust on these professionals as much as on the issuers. They are charged with a duty of due care and should take the trust placed on them seriously and perform their jobs ethically, diligently, and properly. So much of the small investors' savings is at stake.

Role of Exchange and Regulator

The Stock Exchange, as the first-line regulator of listed companies, and SFC as the statutory regulatory body, also have a role. We have become more and more aware that those elements of merit-based regulation in our system must move towards increasingly disclosure-based rules.

In the Main Board, investor protection is achieved through listing rules that allow only companies with track records to offer their securities to the public. This serves essentially as a gatekeeper function. For issuers on the Growth Enterprise Market (GEM), however, with less than two years of track record and no profit record, the future of these companies is more uncertain, and the risks for their shareholders much higher. So we have to rely more on disclosure and the role of sponsors, that is, professionals who should be able to judge the quality of companies better than the layman. It is also why investors have to sign risk statements when they trade on the GEM market.

Listing of high-tech stocks on GEM has sometimes been compared with listing on NASDAQ. And some people see a degree of regulatory competition, in that issuers argue they will list in NASDAQ unless the conditions for listing on the GEM are waived or relaxed to be comparable with NASDAQ or US regulatory standards. This argument misunderstands the differences between Hong Kong and US regulatory approaches. In the US, all corporate disclosure statements and financial accounts are filed with the SEC, which, incidentally, also has oversight over the accounting profession. Disclosure of false or misleading information to the regulator is a criminal offence. The US regime also carries significant fines for misconduct. Moreover, their legal system allows private class action, with potential for monetary awards at three times the actual damages suffered. These potentially financially crippling lawsuits, made easy and accessible to minority shareholders by contingency legal fee arrangements, are a critical link in the US approach to deterring poor disclosure, bad management and misleading information. In Hong Kong, our enforcement tools and regulatory framework are still under debate and evolving. Hence, the risks for the uninformed and uneducated investors are higher.

Moreover, NASDAQ is a developed market, with many experienced professionals and seasoned day-traders in the business. Hong Kong is still largely a retail market, with many small investors being neither experienced nor educated in dealing in volatile concept stocks.

For these reasons, it is not surprising that the Commission views with caution arguments for waivers of regulatory conditions for listing. The Commission will work closely with the HKEx to improve on the regulatory framework that will not discourage small growth enterprises from listing in Hong Kong, while balancing it with the need for adequate investor protection.

Helping small growth enterprises, including high-tech companies, raise capital to turn concepts into real businesses is the very purpose of GEM. Small and medium enterprises have been the bedrock of Hong Kong's success. Big companies are built from small ones. High tech does not change the value in entrepreneurship. Personally, I am confident that GEM, with its mission to facilitate the nurturing of this spirit, will play a positive part for Hong Kong.

There is one area where Internet time will not wait for regulatory reforms. The million or so investors who have queued regularly for IPOs will find electronic access to IPOs much more user-friendly. The SFC and HKEx have set up a task force to push ahead on this front. First, sometime this year the fully automatic exchange trading system AMS3 will go live. Online trading creates a whole new set of challenges for the brokers in their executional capabilities, capacity and advisory skills. It also provides instant trading opportunities for investors as well as instantaneous risks.

Accordingly, the Commission will work closely and urgently with HKEx and Hong Kong Securities Institute (HKSI), as well as the securities community, to develop investor education programmes on the rules of the game for online trading. We put out materials on these issues regularly and you will find us increasing our efforts further. Some advice on day-trading was just published on our Website last week. By mid-year, our eIRC (electronic Investor Resources Centre) will be launched, to bring better investor education information to the public.

Our role is to maintain a level playing field and to regulate the trust relationships mentioned earlier. We will continue to conduct surveillance for manipulative activities or unfair trading. We will push for full and timely disclosure by issuers. And as explained earlier, if an issuer or its management abuses the trust investors have placed on them, diverting capital from efforts to materialize concepts and to deliver on promises for private benefit, the SFC, the Stock Exchange, and the Commercial Crime Bureau of the Police will be there with all the legal and enforcement powers available to us.

Conclusion

Technology has changed our lives and the securities markets beyond recognition. It is not the role of the SFC to prevent investors trying to make money, nor inconvenience issuers from access to capital. However, the Commission is charged with maintaining fair, transparent and efficient securities and futures markets. It is our duty to provide as much protection for the investing public as the law permits us. But the best protection is an informed and knowledgeable investor. We will do our best to remind everyone of the risks and devote greater efforts to investor education. In this area, we will have to work much more closely with HKEx and HKSI.

Technology may have created the New Economy and changed market dynamics. But it has not changed the fundamental functions of the securities market:

- IPOs help entrepreneurs raise capital to invest in businesses that yield a return for their shareholders;
- Shareholders expect the entrepreneurs to be honest, dedicated, transparent and fair in delivering value for their investors; and
- Investors expect markets to be fair, transparent and efficient.

Guiding everything is the Principle of Trust and Confidence. If issuers maintain the trust of investors by delivering on promises, if we maintain fair, transparent and competitive markets, then the trust and faith in Hong Kong as an international financial centre will be maintained. Technology can change overnight; trust and confidence of investors are not built overnight, but they can be lost overnight.

The potential of the New Economy is huge and Hong Kong should be in the forefront of that growth. The Commission will help to facilitate and support that growth, which will bring opportunities and jobs for our citizens. But every society has to balance the need to innovate and the need to regulate. Regulators cannot prevent every accident or every financial crime. In a society governed by the rule of law, regulators can only regulate according to the powers and resources given to them by the people. There are limits to what regulators can do.

Speaking as a former central banker, I have always liked what former US Federal Reserve Chairman William McChesney Martin said, "The job of a central banker is to take away the punch bowl just when the party gets interesting." Everyone likes to join a party, but no one likes to clean up the mess. As the "drink don't drive" campaign says, the best party is when everyone enjoys themselves and knows their limits. When you invest in the New Economy, understand the risks and know your limits.

To sum up, we all have a role in making sure that our markets are vibrant, open, fair, competitive and efficient. But the Commission cannot achieve this without the active cooperation and support of the securities and futures industry and more importantly, our community at large, because the regulator can only function effectively within its powers and authority delegated to it by our community. This is the trust that the Commission has been given, and we will do our best to fulfill that public trust, as openly and fairly as we would expect of those under our supervision.

Chart 1: HSI 1997 vs. 1999/2000

Source: Bloomberg

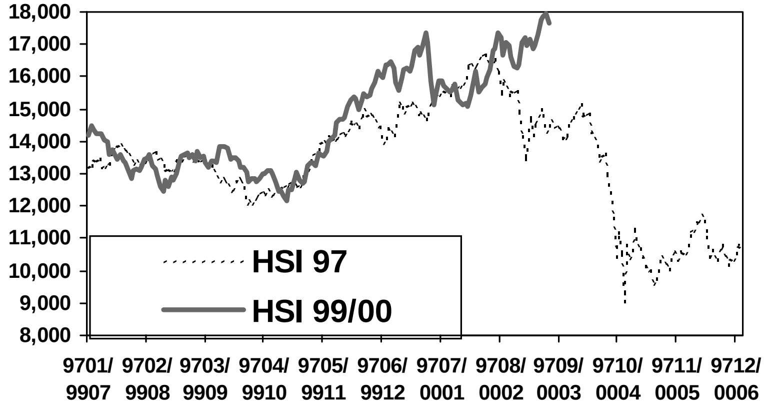
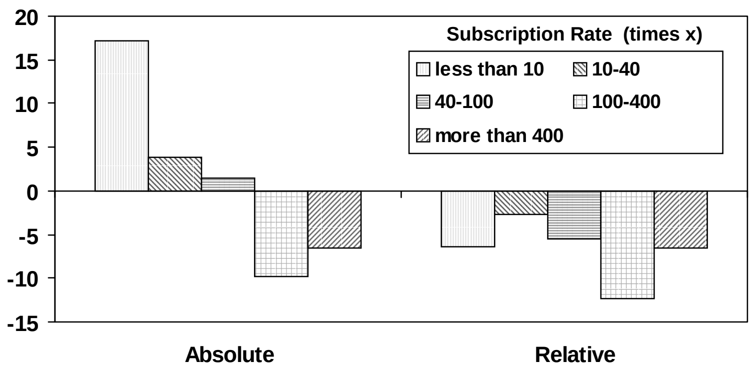


Chart 2: Performance of IPO from 1992 to 1998 (1-Year from 1st Trading Day, %)



Remarks: Absolute refers to stock prices vs. IPO issue prices; Relative refers to stock prices vs. HSI

Source: Morgan Stanley Dean Witter

Andrew Sheng

The New Securities and Futures Bill - A World Class Regulatory Regime for a World Class Financial Centre

20

American Chamber of Commerce
Hong Kong, 13 July 2001

Those of you who have been following the progress of the Securities and Futures Bill would have noted that we are at the Bills Committee stage, meeting twice and very soon as often as four times a week to go through its clause by clause stage. We are very grateful for the hard work of the Bills Committee Chairman, the Hon. Mr Sin Chungkai and his colleagues at the Legislative Council (LegCo) for contributing their valuable time, effort and experience towards getting the new Bill passed as soon as possible, hopefully by the end of this year.

The passing of the new Bill will be no small achievement. This is the last of the 1989 Ian Hay Davison Report recommendations to be implemented. Over 10 years of planning and work have gone into it with intensive efforts by all parties over the past three years. This has been a monumental task led by the Financial Services Bureau, the Department of Justice, and the Commission. I would not be too far wrong in saying that the new Bill has undergone the most extensive and thorough review of major policies and legal principles, with full consultation with the industry at each and every stage since its inception. Even up to this present time, we are still listening to feedback from the market for ways to improve various aspects of the Bill.

Major new regulatory legislation has been passed and pending in other jurisdictions such as the UK Financial Services and Markets

Act of 2000, the new US legislation that removed Glass-Steagall and the Australian Financial Services Reform Bill 2001. The time has come for us to revamp our legislation and bring in a world class regulatory regime which underpins Hong Kong's status as a world class financial centre. With global competition of today, it is imperative that we have a regulatory framework that would accommodate the profound changes wrought by technology on the structure and activities of financial markets.

Against this backdrop, I thought that rather than boring you with details of what is in the Bill, I should invite you to look at how we will implement the Bill. This brings us to the philosophical question of Why We Regulate and How We Regulate the securities markets.

It was a historical anomaly that the existing Securities and Futures Commission Ordinance sets out only the functions of the Commission, but not its regulatory objectives. The new Bill specifically spells out these objectives in order to clarify what the Commission should do to promote market integrity and investor protection. We will be held accountable to the public for the manner in which we meet these objectives.

In essence, what are we here for? The simple answer is that the Commission exists for the investor.

Why Do We Regulate?

Right from the beginning, the new Bill sets out the six principal regulatory objectives of the Commission to:

- maintain and promote a fair, transparent, efficient, competitive and orderly securities and futures industry;
- promote investor education;
- secure an appropriate degree of investor protection;
- minimise financial crime and misconduct;
- reduce systemic risks; and
- help maintain the financial stability of Hong Kong.

These six objectives can be summarised into two broad objectives or themes, which are to promote:

- market integrity; and
- investor protection.

These two broad themes guide us in everything that we do in setting operational priorities and performing our regulatory functions.

How Do We Implement the Bill?

In implementing the law, we aim to regulate firmly and fairly. This may mean we have to prosecute or take disciplinary action whenever anyone transgresses the law. However, our criteria of success is not how many we prosecute, but whether the investors are confident that our market is as transparent, as fair and as free of misconduct as other major international financial centres.

This is a big task, with competing priorities and competing interests between issuers, investors and intermediaries. We do not want to overburden the market with excessive regulation. We all have limited resources. Ultimately we must balance between these interests, our regulatory objectives and regulatory costs. Finding the right balance is therefore essential. We are confident that the way forward is to move towards transparent and accountable *risk-based regulation.*

Risk-based regulation works by firstly identifying and then focusing our attention and resources on *high risk* situations.

In his book, *The Regulatory Craft*, Harvard Professor Malcolm Sparrow states: "The essence of the [regulatory] craft lies in picking the right tools for the job, knowing when to use them in combination, and having a system for recognizing when the tools are inadequate so that new ones can be invented."

The SFC has a good range of regulatory tools to help us carry out our work. These regulatory tools include ordinances, rules, codes, guidelines, principles, regulatory programs, policy projects and compensation schemes. Judicious application of these tools is essential to achieving the SFC's twin objectives of promoting market integrity and investor protection. For example, requiring our registrants to submit Financial Resources Rules (FRR) returns helps us *identify and assess* risks and to address these risks together with the relevant intermediaries. Carrying out market surveillance helps us *monitor and track* risks by, for example, identifying market misconduct. Issuing investor alerts on scams to the investing public helps us to *avoid* risks. Providing investor education programmes helps us educate investors to better assess their risks and protect their rights, a key ingredient for a mature and healthy market.

In implementing the Bill, we will be guided by the principles of *fairness and natural justice*. This means that we stand firm by our decisions if we believe it is in the interest of the investing public or under public interest to do so. We try to ensure that our decisions or actions are generally *consistent with past regulatory decisions*, bearing in mind that each case or situation is considered in light of its own specific facts and circumstances. This also involves the process of ensuring that our decisions or actions are *proportionate* to the wrongdoing in question.

We will also be *transparent* in the way we exercise discretion. There will be a statutory requirement to publish information about waivers - who benefits, what and why (subject to a discretion to hold back information of a highly sensitive commercial nature).

Improving the Quality of our Markets

We all recognize that technology, globalization and intensifying competition have changed our business environment profoundly. Competition is all about quality. As the markets change, so must the regulator. The new Bill not only encourages intermediaries, market participants and investors to embrace higher standards but also addresses the problem of gaps in the existing regulatory framework. It provides new tools and solutions in relation to these areas.

Let me illustrate with a couple of points from the Bill.

Licensing and Intermediaries

Under the Bill, there will be:

- A single licensing system; and
- Senior management of brokerage firms will be responsible for ensuring compliance with regulatory requirements.

Intermediaries will benefit from the new licensing and regulatory regime that will provide a level playing field between banks and brokers. They will also benefit from reduced barriers to entry and more streamlined processes. For example, under the new licensing system, it will only be necessary to complete one FRR return and one annual report instead of one for each type of licence held under the current regime. We are mindful that the cost or burden of regulation should be kept to a minimum, and that the benefit of such regulation should outweigh the cost.

Minimising Market Misconduct

The SFC takes a very serious view of market misconduct as it strikes at the very heart of market integrity and investor confidence.

Currently, market manipulation (a term that includes price rigging, stock market manipulation, dissemination of false information to induce trading, etc.) is a criminal offence. It is, however, increasingly difficult to prove such offences to the criminal standard of "beyond a reasonable doubt".

Under the new Bill, the SFC will have the option of choosing between civil and criminal routes for punishing market manipulation and insider trading. The civil route will involve a Market Misconduct Tribunal chaired by a full term judge and assisted by two members with the necessary expertise. This should improve our success rate in combating misconduct.

The SFC will also have more investigation powers or "tools" in relation to inquiries on listed companies, including obtaining additional information from its officers/employees, and information relevant to an inquiry from auditors, bankers and third parties. This will greatly assist us in gathering the necessary evidence when investigating suspected improper conduct in a listed company.

The new Bill will also create a statutory civil right of action against those found to be responsible for market misconduct and those who have made false or misleading public communications that affect share prices. This is a good step towards increasing investor remedies.

Minority Shareholder Protection

More work on improving minority shareholder protection and corporate governance is required and this has to be done outside this Bill. In particular, we need to look at improving the quality of financial information available to the public, the rights of minority shareholders, encouraging greater shareholder involvement and enhancing institutional investors' involvement in the market. The Standing Committee on Company Law Reform is currently studying these issues and will be making proposals later this year. In the meantime, the SFC has established a Shareholders Group that is aimed at increasing investor protection and improving corporate governance. The first meeting was held last month and we will be keeping you informed on their progress.

Checks and Balances on the SFC

The SFC is keenly aware that no one wishes to be regulated without clear checks and balances. On the other side of the coin is the undeniable fact that adequate powers must be given to the regulator so that it can regulate effectively. The regulator needs extensive powers and discretion not only to protect investors but also to facilitate business. Of course, sufficient checks and balances must be in place to ensure that the SFC uses its powers fairly, reasonably, proportionately, with clear respect to natural justice and due process.

At present, there are various checks and balances already in place. For example:

- The presence of six Non-Executive Directors on the Board of the SFC which provides *independent supervision* of the SFC's executive functions and an important objective perspective.
- The right of an aggrieved person to seek *judicial review* of the SFC's decisions.
- The right of an intermediary who is disciplined or refused a licence to appeal to an independent *Securities and Futures Appeal Panel.*
- Under the new Bill, a full-time *Securities and Futures Appeal Tribunal* (SFAT) will be empowered to carry out a full merits review of all our licensing and disciplinary decisions, including, for the first task, reprimands. The Tribunal, which will be chaired by a full time judge, will have the power to call new evidence, stay legal proceedings, overturn or even substitute SFC decisions.
- The fact that much of our work falls within the ambit of the Ombudsman and the ICAC. Also, the SFC is subject to regular review of our operating Divisions by the ICAC. The last review was carried out this year.
- The requirement that we report suspected market misconduct to and consult with the Financial Secretary before taking certain regulatory actions, e.g. before seeking certain Court orders against listed companies, making a suspension order or making certain rules.

In addition, the Government has established a fully independent audit body, the *Process Review Panel* (PRP), to review the SFC's procedures in relation to our operational decisions and actions. Its term of reference is to ensure that our internal decision-making processes are fair, and give due regard to the requirements of natural justice and due process. In addition, the PRP has the power to audit completed or discontinued cases to check that we have followed these procedures.

I know of no other financial regulator in the world, which is subject to this degree of scrutiny.

The PRP's role is not to review cases on their merits - that would be supplementing the functions of the SFAT. Nor will it be a complaints handling body to supplement the Ombudsman. Rather, it is there to ensure that apart from having reached a fair and correct decision (a matter for SFAT), we have also reached the conclusion through a due process in a fair, reasonable and proper manner. In other words: to ensure that persons who are subject to our regulatory action have, in the process of that action, received due, proper and fair treatment.

To this end, we have thoroughly reviewed our internal processes and procedures, and fine-tuned them so that they are consistent with the transparency requirements of today's market. We are also looking at how certain processes can be further streamlined to dovetail with the spirit and letter of the Bill.

Overall, the provisions of the new Bill and the establishment of the PRP will benefit both intermediaries and the investing public as it will provide greater transparency and accountability on the part of the SFC.

Balancing Act

In conclusion, the Bill, as it now stands, strikes a good balance in providing sufficient flexibility for market innovation and delivering adequate investor protection and accountability of the regulator.

The SFC will continue to implement the law without fear or favour, fully subject to all the checks and balances that we have built into the system. As the regulator and custodian of the rule of the law in the securities and futures markets, we must set high standards of due process and accountability. Our powers come from the market because it wants firm and fair regulation. We will always listen to and work closely with the market.

Our process of market consultation and feedback is pretty thorough and will be incorporated into the law. Before any code or rule is changed, we undergo an elaborate consultation process. First, a consultation paper is drafted. This may, depending on the issues, be referred to our newly revamped Advisory Committee, comprising 16 experts from all sectors of the securities and futures community for industry advice. We have also established a good number of working groups of market participants and experts to work alongside us to examine policy and drafting of subsidiary legislation, codes and guidelines under the Bill.

Once the Advisory Committee or user group has given their advice on the consultation paper, it goes before the full Commission, which meets monthly, for approval. It is then released for full market consultation, with consultation periods of between one to three months.

Once submissions have been received, we consider market views that may result in revisions to, for example, a final code or rule change before they are put to the Commission for approval. We meet regularly with the stakeholders, press and LegCo members to brief them of our activities and purposes.

In addition, we are working on a 3-year strategic plan that will help us prioritise and focus our efforts in critical areas. We have also commissioned an independent external survey of stakeholders' views to find out how the market thinks the SFC is doing right or wrongly.

With all these measures in place, I can honestly say that we will have a world class regulatory framework for Hong Kong as a world class financial centre. As I am fond of saying, the proof of the pudding is in the eating. We are content to be judged on our impartiality, professionalism and performance. And we are ready for that judgement.

Finally, let me give my sincere thanks to everyone who has worked so hard to take the Bill to this penultimate stage. Credit must go to colleagues in the SFC, Financial Services Bureau, the Department of Justice and other professional bodies who have contributed so much.

Like our counterparts in the UK, the Financial Services Authority, who are looking forward to N2 when the Financial Services and Markets Act will come into force, we too can look forward to the day when our Bill becomes law.

Postscript

The Securities and Futures Ordinance was enacted in the Legislative Council on 13 March 2002.

Andrew Sheng

The Art of Financial Regulation Managing Stability in Changing Times[1]

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2002 ASIC Summer School
Brisbane, 18 February 2002

I am very honoured to be invited to give this Keynote Address to the ASIC Summer School. The ASIC Summer School is an excellent example of how securities regulators can get together and share knowledge and experience with each other. I want to congratulate ASIC, under the able leadership of David Knott, for sponsoring another Summer School in this beautiful city of Brisbane.

In May 2000, I attended the Sydney IOSCO Annual Meeting, where Harvard Professor Malcolm Sparrow was invited to give a talk following his lectures to the Summer School that year. Professor Sparrow's lecture, based essentially on his book "The Regulatory Craft"[2], made such a powerful impression on me that I was determined to go back to Hong Kong and implement his key message. I put his message on my PC screen saver to remind me what he was trying to drive at. This was: *"Pick Important Problems, Fix Them and Tell Everyone"*. His book is the most important book I have read about regulation in general.

The other main academic source for this lecture stems from the work in financial regulation by Professor Charles Goodhart, the doyen of central banking and monetary policy economist, famous for Goodhart's Law of Monetary Policy. In November 2001, the Bank of

[1] I am grateful to Ms Tan Gaik Looi of the Securities and Futures Commission (SFC) for research work in the preparation of this lecture. The views expressed are entirely personal, and not necessarily those of the SFC.

[2] Sparrow, M.K. (2000), 'The Regulatory Craft: controlling risks, solving problems, and managing compliance' (US: The Brookings Institution Press)

England invited me to give a "Festschrift" essay in his honour, entitled "Is there a Goodhart's Law of Financial Regulation?"[3] The answer of course is Yes. This is because the relationship between the financial regulator or central bank and the market is reflexive or inter-related. The nature of the financial regulation game changes because the regulator and the regulatee are part of the same game. Your behaviour changes the regulatee's behaviour and the market's response in turn could change your policy behaviour.

Goodhart[4] sees financial regulation as a contract between the regulator and the regulatee with very important incentive structures. If the incentives are wrong, for example, then markets can become distorted. For example, excessive deposit insurance can create moral hazard behaviour in bankers.

Consequently, this lecture draws upon the theoretical input of Professor Goodhart, the regulatory insights of Professor Sparrow, plus my own experience in finance, first as an accountant, then as a central banker in banking and insurance regulation and currently, as a securities and futures regulator.

A Changing Financial Landscape

Since the Asian crisis, we have got a much better understanding of the nature of financial sector problems but we don't necessarily have good answers. We know we should raise accounting standards and bring regulatory standards toward global standards. Given increased risks, we understand we need to enhance surveillance, share information

[3] Sheng, A., and Tan, G.L. (2001), 'Is there a Goodhart's Law of Financial Regulation?' Paper presented at Bank of England Festschrift for Professor Charles Goodhart, 15-16 November (London)

[4] Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suarez, L., and S. Weisbrod (1998), 'Financial Regulation: Why, how and where now?' published in association with Bank of England (London: Routledge)

and make contingency plans. But the environment is changing far too rapidly because of four major trends: technology, globalization, competition and restructuring.

Technology: technological growth is so fast and bewildering that like you, I have struggled to understand its implications. I have finally understood *that all financial markets are networks*. Metcalfe's Law[5] basically says that the value of a network is exponentially related to the number of its users. So the wider the network of users, the more valuable the network and its network externalities. This explains why banking networks are converging horizontally and vertically, linking and merging with securities networks, insurance networks and even consumer networks.

Networks are public utilities, which create a public good. But the minute you link disparate networks together, their problems are your problems, and, your problems their problems. So network economics and network externality effect drive globalization, which is the linking of local networks to form global networks. It has driven on-line trading, which has created 7 x 24 (7 days a week 24 hours a day) transactions. Consequently, markets don't sleep, so regulators can't sleep. In other words, technology and globalization have changed the whole market structure and also the nature of competition.

Convergence in the name of economies of scope and scale has also created vertical and horizontal mergers and alliances between exchanges as well as larger global financial conglomerates. A recent BIS research article has tried to explain why foreign exchange trading globally has actually declined. Part of the answer is, of course, the emergence of the Euro, which eliminated the need for multiple cross trading of European currencies.

[5] Carl Shapiro and Hal R. Varian (1999) 'Information Rules - A Strategic Guide to the Network Economy' (US:Harvard Business School Press)

But the BIS also pointed out that the number of foreign exchange players has physically declined because of mergers and acquisitions.[6] Banks have merged with insurance companies and fund managers. Fund managers have become so large that Fidelity alone manages over US$1 trillion in assets, larger than many banks and countries. These mergers have created multinational "large and complex" financial institutions (LCFIs), which provide the whole range of financial services, some under one brand name, while others are part of a holding group of local and boutique entities.

Once they consolidate, they do not need so many branches or even many regional offices. This local and global trend of concentration and consolidation of activities into larger and more powerful players is quite similar to how Wal-Mart, with its supermarket quality of service, has forced the mom and pop retail business to restructure in the United States.

Globalization has blurred the jurisdictional lines, both within markets and cross-border. Where does an electronic transaction stop, when an Australian trades Brazilian bonds via a Hong Kong broker who clears the transaction via New York? Property rights are being exchanged across different time zones and different geographical boundaries, cutting across the jurisdictions of banking and securities regulators.

We have global markets, but our laws and regulations are all local. Hence, how do we protect the investors' property rights when there are no global laws?

Amidst these technology and global changes, *competition* has become very intense. The range of new financial products that is emerging is bewildering, and new players, such as hedge funds, are changing the way we look at markets. Who would have expected that in the first half of last year, one quarter of Hong Kong's savings went to capital-guaranteed products with derivative features? These products were offered by banks that are now launching hedge funds of their own to compete with brokers and asset managers.

6 Bank for International Settlements (2001), 'Why has global FX turnover declined? Explaining the 2001 triennial survey', *Quarterly Review: International Banking and Financial Market Developments*, December

Indeed, hedge funds are new financial animals that are neither homogenous nor aptly described. Many of them don't even hedge. They simply use very different, complex derivative tools and investment strategies. Many of them operate from offshore financial centres, and they are not properly supervised. In some markets, they account for as much as one quarter of market liquidity.

As we all know, when financial innovation and competition arrives some people gain while others lose. The financial sector must undergo *restructuring*. Domestic banks are facing foreign competition, while smaller financial institutions cannot compete against larger institutions. Old franchises are eroding, so losses begin to accumulate in the financial sector. These losses appear either in the form of non-performing loans or intermediary failure. Of course, intermediary failure is not simply due to excessive competition or bad management. Real sector shocks also cause weaker financial institutions to fail. But the fact that intermediaries fail under regulators' watch means that we can never escape part of the blame.

Pressure for Regulatory Reform

Because of these rapid changes, there's huge pressure for regulatory reform. These structural issues basically challenge the regulators' competence, effectiveness and efficiency. It forces us to question what we are all about. Thus, we need to understand why we regulate, how we do so, and how we are accountable to the public. Recent questions about regulatory costs, clarity of responsibilities, accountability, conflict of objectives, regulatory arbitrage, competitive neutrality and public confusion of who does what are all part of the social debate over the proper role of financial regulation.

In sum, financial regulators need to understand the environment around us. Given that regulatory polices and processes need to change, the big question is "How do we build a flexible regulatory structure that responds to such dramatic changes?" Either we change or a crisis will force us to change. It's as simple as that.

Public Sector and Financial Regulation Objectives

The role of financial regulation and its objectives and processes must be put in the context of public sector reform objectives. The best statement of public sector objectives is the view of the Australian Government[7] that the public expects a public service that:

- uses resources efficiently, effectively and ethically, to achieve the best results at least cost to the Australian taxpayer;
- provides honest and robust policy advice to the Government;
- delivers fair, effective, impartial and courteous service for all Australians and is responsive to community needs;
- ensures high standards of public accountability;
- competes with, and benchmarks against, best practice in other sectors on both cost and quality;
- fosters a more contestable environment;
- manages for results;
- promotes innovative organizational arrangements; and
- contributes to Australia's international competitiveness.

This set of criteria applies equally to the role and performance of financial regulators.

[7] Public Service and Merit Protection Commission (1998), 'An overview: Reforms to the APS - What we are doing' (Commonwealth of Australia)

Objectives of Financial Regulation

So what are the objectives of financial regulation? Professor Charles Goodhart suggests that it is to influence the behaviour of intermediaries so that the policy objectives are achieved. Of course the policy objectives can be very different in different economies. But there is a regulatory cycle that applies in every economy. Once you have defined your *policy objectives*, like any decision cycle, there must be a set of *processes or procedures* to achieve these objectives. The operation of these regulatory processes results in a set of *policy outcomes*. As the old saying goes, "the road to hell is paved with good intentions" or in regulatory speak, the outcomes do not fit your objectives. You therefore need a policy review to see whether the objectives are wrong or the processes are wrong.

Which brings us back to Malcolm Sparrow's classic example of policy objectives and policy outcomes. That is the case of income tax non-filers. The policy objective is to collect as much tax as possible. The tax collection process was based on filing an income-tax form, upon which the tax was collected. When the US Inland Revenue reviewed this problem, it discovered to its horror that the biggest tax loophole was that of the non-filers. If a person does not file the income tax form, you can't tax him. There was no process to tax the non-filer and there was no process to catch the non-filer. So the policy outcome was that people who were reporting and paying tax bore the tax burden, while the non-filers did not pay tax at all.

In other words, the processes did not meet the policy objectives, and the result may be a wrong policy outcome.

Surely we need to review many of our own financial regulatory processes or procedures that were put into place in the 1980s or 1990s to see whether they meet policy objectives of the 21st century?

What Malcolm Sparrow suggests is that you need to clearly define your objectives, then lay down effective processes to achieve the desired policy outcome. If the outcomes do not fit the objectives, the credibility of the regulator is eroded. Everyday I ask myself, "Have I picked important problems, fixed them and then told everybody?" It sounds like common sense, but common sense is not too common.

The bit about "tell everybody" is important, because as financial regulators, we have to be tough in enforcing the law. Many of us do very good work but we don't tell anybody. Because the public does not understand what we are doing, they may not support us when we need laws that give us the powers to enforce the law effectively. Hence, we need to explain what we do to the public in order to achieve regulatory credibility.

The International Organization of Securities Commissions (IOSCO) sums up the objectives of securities regulation as:

- Protection of investors
- Ensuring fair, efficient and transparent markets
- Reduction of systemic risk

The UK Financial Services & Markets Act 2000, sets out the objectives of the FSA as promoting:

- market confidence
- public awareness
- the protection of consumers
- the reduction of financial crime

The US SEC's mission statement is simply: "we are the investor's advocate".

While these objectives are correct, applying the Sparrow dictum, I would simply say that *our job is "to make the market work better"*. In other words, when financial markets don't function well, the investor gets hurt. Allow me to illustrate what I mean.

The Functions and Nature of Financial Markets

How do we make markets work better? Applying the Sparrow dictum again, we can only identify important problems if we understand clearly the functions and nature of financial markets. Basically, there are four functions of financial markets:

- price discovery
- resource allocation
- risk management
- corporate governance

The Asian crisis was an excellent example how these four functions were not performing well in Asian markets. First of all, price discovery. Are financial market prices reflecting the risk? In the Asian crisis countries, the average non-performing loan ratio was between 15% to 50% of total bank loans. Since the average bank spread (lending rate less deposit rate and administration costs before provisions) was roughly 1.5%, how could the banks clean up their non-performing loans from their current bank spreads? Another example is an excessively high price-earnings (PE) ratio. A PE ratio of more than 50 implies that the cost of funds to issuers is less than 2%, which may encourage issuers to waste such cheap funds on investment in inefficient capital assets.

Secondly, resource allocation - is the market distortive? Nearly three quarters to over 100% of domestic savings in Asian financial systems are in the banking system, while debt markets are shallow and securities markets tend to be speculative. Are capital markets exercising sufficient discipline on the use of savings in Asia, particularly if governments, through policy guidance on interest rates or directives, determine the use of domestic savings? Why has Asia been more prone to asset bubbles in the 1990s?

Thirdly, capital markets are supposed to help investors hedge their risks. But how can investors and borrowers or issuers hedge their risks when derivative markets in Asia are generally under-developed? Moreover, do policy makers and investors understand that long only strategies actually increase risks for investors?

Finally, are financial markets punishing poor corporate governance? If not, how can regulators help to raise the quality of corporate governance?

Quality of Markets

If regulators care about the quality of markets, then I propose that we examine this by breaking down the quality of markets into seven components - what I call the seven "I's" of markets. They are:

- Information
- Incentives
- Issuers
- Intermediaries
- Infrastructure
- Investors; and finally,
- I, the regulator

Information and Markets

The first thing to remember is that *timely and accessible information is a market fundamental.* Markets cannot function well without highly reliable information. When information is not accurately disclosed in a timely manner, or when selective or misleading information is given, market fairness, integrity and the level playing field are called into question. You also cannot engage in sound financial regulation unless you have good information on the state of the financial system.

To have good information, you need to have international accounting standards (IAS) and good auditing standards. Enron, which is currently the largest corporate failure in history, has demonstrated clearly that without good information and good checks and balances in accounting and audit, large companies can fail even in the best-regulated markets.

My personal lesson drawn from the Asian crisis is that bad accounting = bad information = bad decision making = bad risk management = financial crisis.

Incentives

A long-serving securities regulator told me, when I first became a securities regulator, that securities markets are all about greed and fear. I did not understand this well, as I came from the background of a banking regulator. Bank regulators are referees, in a world where bankers are generally risk averse. On the other hand, the securities markets understand very well the nature of risk and speculation. Securities are relatively easy to manipulate through insider trading, market manipulation and fraud. Millions can be made or stolen because markets trade quickly and often opaquely. If a market manipulator thinks that he cannot or will not be caught, he will simply rob the market blind. The only thing that stands in the way of financial crime, often times, is the quality of financial regulation.

Of course, not all securities regulators are financial cops. In Hong Kong, the regulation of securities markets is shared between the Stock Exchange as regulator of financial disclosure, the SFC on insider trading and market manipulation, the Commercial Crime Bureau of the Police on fraud and theft, and the Independent Commission Against Corruption on corruption in the industry. In addition, the Financial Secretary can appoint Inspectors under the Companies Ordinance to investigate special cases of fraud. What deters manipulation of the market is whether we can catch the perpetrators. Consequently, we need to co-operate very well with other agencies in the enforcement field in order to minimize financial misconduct and crime.

In other words, for markets to function well, the incentive structure must be evenly balanced. If the risks and rewards are imbalanced, the markets will be distorted by greed without the fear of being caught.

Such incentive structure also applies to regulators. Charles Goodhart recognized very well that regulation is a thankless task, where the public is quick to blame regulators for mismanagement where failures occur. In many emerging markets, financial regulators are grossly underpaid relative to the market, while the laws or the criminal investigation and enforcement systems are not well developed to deter financial crime.

Moreover, since regulators get their power from regulation, it is totally understandable why they may concentrate on areas that enhance regulatory power, such as licensing, and shy away from very tough and unpopular areas, such as enforcement and sanctions. In the words of Taiwan lawyer, Professor Lawrence Liu, "Asian regulators tend to over-regulate and under-enforce." Tough enforcement wins no friends, but it is a job that has to be done effectively for markets to function cleanly and fairly.

Issuers

The quality of a market is determined by the quality of the companies that raise capital from the public. At the end of the day, they have to provide an appropriate risk-adjusted rate of return to investors. Well-performing companies would attract more investors and enhance the liquidity of their stocks. Liquidity begets liquidity, attracting better quality issuers, financial intermediaries and investors in a virtuous circle that improves the quality of markets.

The first and foremost persons responsible for the quality of a company are its management and controlling shareholders. They set the standards of ethics and performance that the company is judged by.

Good corporate governance is all about three levels of *discipline*. First of all, rely on the management or controlling shareholders to exercise *self-discipline*. This works when the controlling shareholders or management are highly ethical and treat minority shareholders fairly.

The system breaks down when the internal checks and balances, such as independent board committees, internal and external audits, and the transparency of disclosure do not function well. The OECD has published a Code of Corporate Governance that benchmarks corporate behaviour.

Where self-discipline alone does not work, we need *regulatory discipline*. Regulators must set the rules of the game in consultation with the private sector, preferably to international standards, and enforce these agreed rules, fairly and transparently. They must also protect investors through greater public education and disclosure rules. When cheating or fraud occurs, there must be the discipline to take necessary enforcement action.

In Asia, policy makers have tended to rely on self-discipline and regulatory discipline, without paying enough attention to *market discipline*. Companies, when protected from competition, may develop cartels or monopolistic tendencies that do not treat consumers or investors fairly. These may deter foreign or minority investors from entering the market when they perceive that they are not treated equally.

Good corporate governance requires all three disciplines to keep the checks and balances for healthy companies.

Intermediaries

Financial intermediaries are the middlemen between the suppliers of capital and the users of capital. They perform also the front-line quality control work in capital markets. Investment bankers act on behalf of issuers, advising and underwriting IPOs and mergers and acquisitions. They are supported by accountants and legal advisers who play a key role in due diligence of information disclosure to professional standards. The higher the quality of intermediaries, the more the financial regulators can rely on the market to exercise discipline on the market participants.

For intermediaries to function well, they have to act professionally and ethically, free from the conflicts of interest that could cloud their independent judgement and due diligence. The quality of information depends critically on the quality of such independent professional advice, benchmarked against international standards.

Indeed, it is precisely the lack of high quality intermediaries that many securities regulators find themselves having to take direct supervisory action on markets. Consequently, in many emerging markets, securities regulators find themselves in a developmental role, trying to nurture the growth of quality intermediaries. Unfortunately, the tendency of many markets to protect domestic intermediaries and resist the importation of foreign intermediaries with their international skills, means that market development tends to be retarded.

Infrastructure

Financial markets have trading, clearing, settlement and payment processes that are transacted across networks. The infrastructure in place may either be paper-based or provides for electronic transactions. The quality of the infrastructure determines the size of the *operational risks*, since failures due to human error, hardware or software failure, and natural or terrorist attacks can disrupt markets as September 11 has shown so dramatically.

The financial infrastructure comprises not only the platform and processes to ensure that markets function in an orderly and robust manner. It comprises also a legal framework and efficient and fair judiciary that protects property rights of market participants.

Increasingly, IOSCO and the Committee of Payment and Settlement Systems (CPSS) of the Basle Committee of Banking Supervisors have recognized the importance of the robustness of trading, clearing, settlement and payment systems in managing financial market risks.

In addition, there is a need for balanced markets for risk management. The Asian crisis demonstrated that not only was there incomplete information, but also incomplete markets. In many parts of Asia, the bank-dominated financial systems did not possess cheap and liquid bond and derivative markets to enable investors and issuers to diversify and hedge their risks at reasonable cost. Regulators must therefore pay attention to the market development dimension so that there is a sufficient range of instruments and markets for overall national risk management.

The concentration of risks in a few sectors without the ability to hedge such risks was one of the problems exposed by the Asian crisis - a failure that is still unresolved in many economies.

Investors

Ultimately, the quality of markets depends on the quality of the investor. All too often, uneducated investors chase rumours and are under-served by poor quality intermediaries, resulting in continuing losses through poor risk management and following the herd. Investor education is an important supervisory tool to promote investor protection. Regulators normally provide sustained outreach programmes to educate investors. The SFC has an investor education website (HKeIRC - electronic investor resource centre) that provides the essential ABCs of investment, games to test the knowledge and understanding of investors, and also 550 links to over 400 websites around the world.

It is important for investors to understand the concept of risk and return, know their rights, ask the right questions of their brokers and financial sales people, and know where to check to verify information and clarify their doubts. Shareholder activism is also good for markets as it imposes greater market discipline on companies and protects minority interests.

I, the Regulator

Last but not least, the quality of markets must depend on the quality of the regulator. In his book, Malcolm Sparrow has this quote from an OECD report -

> "Too often, legislators issue laws as symbolic public action, rather than as practical solutions to real problems. Regulatory inflation erodes the effectiveness of all regulations, disproportionately hurts small and medium businesses, and expands scope for misuse of administrative discretion and corruption."

All financial regulations have a cost, which creates incentives for regulatory arbitrage. Goodhart points out that there is also the danger that regulators could over-regulate, particularly as the public may perceive regulation as a free good. Whenever there is a crisis, regulators may over-react to minimize future failures and avoid blame by supplying more regulation. The balance between the need to enforce without over-regulation is a fine line.

No financial regulator can exercise his powers without public support. To obtain public support, regulators must have four public attributes. Three of these (Gong Pin 公平, Gong Zheng 公正, and Gong Kai 公開) are enshrined in the Chinese Securities Law, to which I would add a fourth Gong Xin 公信. Namely, fairness, integrity and transparency, to which I have added public trust.

The Tools of Regulation

No survey of financial regulation can be complete without a quick overview of the tools of regulation. There are different types of regulation: prudential regulation, conduct of business, systemic stability, competition, market supervision and disclosure, system integrity, etc. Each type of regulation requires different regulatory approaches and tools as determined by their defined objectives.

There are prescriptive rules and differentiated rules. Prescriptive rules apply one rule to everybody: one size fits all. Differentiated rules do not apply standard ratios but apply rules according to the level of risk.

There are entry rules that govern licensing, capital and liquidity requirements. There are also rules on conduct - surveillance, monitoring and discipline, and exit - failure management, investor compensation schemes and insolvency. But we should not forget, rules are only as good as their enforcement. Regulators have to be visible - they must be seen to be regulating and enforcing the law.

What Sparrow points out is that if we have scarce resources versus a whole array of problems, we have to focus our attention on problems where the risks are greatest. We have to adopt a risk-based approach to regulation. In adopting this approach we need to understand that different tools may have conflicting objectives. For example, licensing requirements can be used to discriminate against foreign entry or entry by smaller intermediaries, which may inhibit competition.

To quote Sparrow again, "The essence of the Regulatory Craft lies in picking the right tools for the job, knowing when to use them in combination and having the system to recognizing when the tools are inadequate so that new ones can be invented."

In other words, given different regulatory objectives, the regulator must choose a combination of regulatory tools to achieve these objectives. However, there is a trade-off of objectives and tools, so that the regulator must exercise judgement on the effectiveness of regulation and the policy outcomes. Regulation is as much a craft as an art.

Models of Regulation

I will round off this part of the regulatory survey with the question: "Who regulates what?" Who regulates depends upon the regulatory model. There are four basic models of financial regulation.

The US model is the most functionally duplicative system of specialist regulators in the world. In the banking area, there are four regulators: the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the State Regulator and the Federal Reserve. In the securities area, there is the SEC plus the CFTC. And the securities business of investment banks is partly overseen by SEC and partly by the Fed. There are different state regulators for insurance.

Hong Kong is closer to the US model. The Hong Kong Monetary Authority is in charge of the currency board and banking supervision. The Insurance Commissioner looks after insurance. The SFC takes care of the securities and futures markets and there is a Mandatory Provident Fund Authority that oversees mandatory retirement funds.

Australia has gone for a twin peaks model, organised on the basis of regulatory objectives. ASIC looks after corporate regulation and public offering of securities. Australian Prudential Regulatory Authority looks after banking supervision and supervision of intermediaries. And the Reserve Bank of Australia looks after monetary policy and systemic stability. On top of all that, Australia also has a competition authority to look after competition policy.

What the UK did was to merge several self-regulatory organizations (SROs) and the regulatory wing of the Bank of England into a super-regulator, the Financial Services Authority (FSA). The FSA looks after the whole range of banking, insurance, securities, pension and mutual funds, and also consumer interests.

There is no ideal division of labour between central banks and supervisory authorities. The super central bank model is the Monetary Authority of Singapore (MAS), which is in charge of every aspect of its financial sector including financial market promotion.

Which model is ideal for which economy depends upon local conditions of institutional and legal history and the defined set of policy objectives. There is no single structure that fits all markets and all economies. Irrespective of what model is adopted, my view is essentially pragmatic: as the late Chinese leader, Deng Xiaoping liked to say, "It does not matter whether the cat is black or white, as long as it catches mice." What is important is the need for better coordination and information sharing among regulators in order to achieve the objective of making the markets function better.

Malcolm Sparrow's Six Themes of Regulatory Practice

Let me now try to use the Sparrow methodology to look at how regulators can work better to make the market function better. He has characterized old-style regulators as, "nitpicking, unreasonable, unnecessarily adversarial, rigidly bureaucratic, and incapable of applying discretion sensibly."

For the new-style regulator, Malcolm Sparrow suggests six main themes on regulatory practice:

- cut obsolete regulations;
- reward results, not red tape;
- create regulator-regulatee partnership;
- negotiate, do not dictate;
- reduce regulatory reporting burdens; and
- search for results that count.

There are essentially three core elements:

- Focus on effect/impact/results;
- Adopt problem-solving/risk-control approach; and
- Invest in collaborative partnerships.

Pick Important Problems…

The problem with our daily jobs is that we pay too much attention to the urgent and not the important. Let me illustrate with how we drew lessons from the Asian crisis and applied them in our daily work.

I was asked to assume the Chairmanship of the SFC in October 1998, in the midst of the Asian crisis. Although there were myriad problems to solve, I asked myself what were the big important problems to tackle. Fortunately, I met a good friend, Dr Noordin Sopiee, Director-General of the Malaysian Institute of Strategic and International Studies (ISIS), who told me that in a crisis, don't pick all problems, pick the top three.

This good advice is a rediscovery of a Chinese maxim from 1st millenium BC, Zuo Chuan: "To stabilize a country, top priority must be given to the most significant matters". (安定國家 ， 必大焉先.)

In 1998, in the wake of the Asian crisis, the Hong Kong Administration embarked on a three-pronged reform programme to address structural issues in the securities industry as follows:

- Market reform: demutualization, merger and listing of stock exchange, futures exchange and clearing house to align the institutions with market incentives;
- Infrastructure reform: to move rapidly to a fully electronic web-friendly world-class infrastructure to enhance efficiency, reduce costs and risks;
- Legislative reform: the consolidation of 11 separate Ordinances into a new Securities and Futures Bill.

I am pleased to report that almost all of these reforms have been achieved, with the New Bill likely to be approved by our Legislative Council in March, after nearly ten years in the drafting and debate. We are now in the second phase of reforms, which is also three-pronged: market and product development; strengthening and monitoring the institutional structure, and internal strengthening of the Commission to meet the challenges of the new Millenium.

... Fix Them, and Tell Everyone

Indeed, I have discovered that analyzing the technical problems and coming up with the technical solutions is far easier than the problem of managing human communications and mobilizing support for reforms. That turned out to be a more complex problem and challenge than I had earlier anticipated. To engage in any public sector action, such as restructuring or reforms, you need support from the community and the major stakeholders.

The greatest challenge in problem identification and its solution is essentially how to sell the message that any reform is widely accepted as a win-win situation. Stakeholders and vested interests are by nature suspicious of change, and they automatically adopt a defensive or adversarial approach towards the proponents of change.

The natural reaction was: "How can I support the reforms if I don't understand what they do to me?" This is why the "tell everyone" part is so important.

In the drafting of the Bill and the demutualization of the exchanges, we had to engage the securities and community leaders, and persuade them that the suggested reforms were for the best interests of Hong Kong. During the process of engagement, we discovered that we may not have thought through clearly all the issues and the implications. And through long hours of dialogue and dinners with stockbroker associations and registrants, we were able to slowly *build ownership* and consensus on the need to move forward.

To do so required transparency, accountability and credibility on the part of the Commission, none of which could be achieved overnight. The Commission revamped its Advisory Committees, created a Shareholders Group, Academic Advisory Groups and also launched stakeholder and investor surveys on how the SFC was perceived, whether it was effective or not, and where it could improve. The

Commission stepped up its investor education programme, started to publish quarterly reports and newsletters such as SFC Alert, to reach out to the public. Our website has an average daily page hits rate of over 200,000.

To assure the public that the Commission would not use its investigatory powers capriciously or arbitrarily, a Process Review Panel was established last year, chaired by a prominent banker and comprising stockbrokers, accountants and legal experts, to independently review all completed cases by the Commission. The Panel would examine the work of the Commission to ensure that proper procedures of due process and fairness have been followed by the Commission. As far as I am aware, we are the first securities regulator around the world to adopt such stringent checks and balances.

Thus, Malcolm Sparrow is right that you need to tell everyone that you are fixing problems. But you cannot tell everybody unless you have a good story to tell. You have to be very clear in your own mind what your objectives are, what your processes are and how you manage for concrete results. Credibility is important because the job of securities regulators, for those of us who are financial cops, is not a popular one. The community must understand why you have to be tough to exercise regulatory discipline, and should back you in such work.

To sum up, problems in processes and procedures occur in all markets. But often, people are blamed and they naturally resist these changes. The point that I want to make is that more often than not, it is the lack of clarity in policy objectives and obsolete processes and systems that are to be blamed. Change is the only constant and regulators need to change to be on top of the job. We need to get ownership by those who are affected, including the staff of our own organization, before we can change. Moreover, we need to get the public behind us in order to have the mandate to regulate and enforce.

Supervision, Crisis and Restructuring

I want to conclude this survey of financial regulation by making some comments on the issue of financial sector restructuring. Most regulators are concerned about the bread and butter work of the supervision of entry and conduct of intermediaries in the marketplace. They tend to forget that the exit of intermediaries is part of the natural cycle of markets. If there is no orderly way of exit, some intermediaries disappear through financial crises.

Because we are in a changing world, crisis occurs. This is most prominent in the area of banking, since banking failure is a distinct feature of the 1990s. Securities markets witness much more market volatility, and securities intermediaries are quite good at managing market risk. However, September 11 and the recent failure of intermediaries, such as the collapse of a small broker in Hong Kong, remind us that we all need to deal with intermediary failure.

One of the lessons I drew when I researched at the World Bank about banking failure[8] in the 1980s, was that *bank crisis is an event, but bank restructuring is a process*. What is more important is how we deal with it or prevent it from recurring.

Financial crisis is a messy business, which usually starts off with everyone blaming everyone else, resulting in lots of confusion and little action. But the essence of financial restructuring is very simple. It is a process that is about four fundamental steps, sometimes sequential, sometimes in parallel: *diagnosis, damage control, loss allocation and getting the incentives right.*

In the Sparrow language, *diagnosis* is about identifying the problem. The list of seven I's is a useful checklist for the diagnosis of where the problems lie in the marketplace. If you ask the right questions, the answers very often become fairly obvious. In identifying the problems, you may wish to ask these types of questions:

- What are the risk implications of market and macro economic developments?

[8] Andrew Sheng (1996), ed. 'Bank Restructuring: Lessons from the 1980s' (Washington, DC: The World Bank)

- Are there emerging gaps between regulations and market developments?
- Have you stress-tested the markets and infrastructure relative to the risks?
- Are current incentive structures reducing or magnifying risks?
- Are there patterns of risk concentration?
- Are markets and investors aware of emerging risks?
- Have you double-checked your analysis and solutions with market practitioners?

Damage control means that regulatory action must be taken to stop the bleeding. If action is not taken quickly, losses can escalate rapidly. Regulatory forbearance only delays the pain. No decision is still a decision. You got to keep the relevant decision-makers informed and prepare the public at the appropriate time for the emerging problems.

The recognition of losses, and *loss allocation* is politically the most difficult to accept and implement. Financial crises typically occur when the losses have already been incurred but are not critically recognized. There is a natural tendency to defer dealing with the issues, precisely because they are difficult. As in taxation, everybody avoids paying taxes where they can. In essence, intermediaries fail when the shareholders no longer have the capital to bear the losses, and these losses are either passed to their creditors or to the public. The losses will not go away on their own accord, even if they are ignored.

The best illustration of this is in bank failure, although parallel instances can be found in the failure of other types of financial intermediaries. If a bank fails, either the shareholder pays up or the depositor pays. Because the Government does not want the depositors to lose, through implicit or explicit deposit insurance, the public pays. Strictly speaking, the Government pays either by taxing the people today (which is not popular) or by taxing future generations by borrowing to finance the losses.

Once you've understood this issue, you need to mobilize political and public backing for your action. The process of communication to the public has to be well co-ordinated and managed.

The next question is, "Have you adequate resources and skills to undertake this damage control?" That is a managerial and policy issue. That's why regulation is a thankless task but it is a job that needs to be done, however unpopular the task. We want to be financial doctors, not under-takers.

But fixing the problem and telling everyone would not solve the problems if the basic structure of the market is distorted. In other words, if you wish to remove the underlying problems, you have to *get the incentives right*.

For example, the only way to solve financial misconduct is a tough enforcement process. And financial crime and bad intermediary conduct will thrive when there is no regulatory credibility that the perpetrators will be caught. They will continue to break the rules because it pays to do so. Hence, very often the only downside to financial crime is the enforcement process. Justice must not only be done, but also seen to be done. That is why credible enforcement action must be visible. There is an old Chinese saying that describes this well: "Kill chickens to scare monkeys".

But given scarce resources, and checks and balances, we have to be realistic that we cannot prevent all financial crime, deliberate fraud, or even managerial incompetence. We also cannot prevent ignorant investors from being gullible to promises of quick gains. In boom times, regulators who warn about the need to be tough may be ignored, because everyone wants the bubble to carry on. But the least we can do is to try and minimize financial misconduct and crime, and educate the public about what we are doing. Regulatory credibility is hard to earn but is easily lost.

We also have to be realistic that financial risks and vulnerabilities are changing daily. September 11, Enron and other headline cases are all the aftermath of a decade of unprecedented growth and inflation where even the integrity of information has sometimes become inflated.

We are not clear how the global deflation and structural changes in the real economy will affect the financial systems that we are responsible for supervising.

All we can understand is that markets always adjust, sometimes smoothly, sometimes abruptly.

Conclusions

To conclude, what I am trying to say is that the markets are changing so fast that financial regulators have to change with the times. Such dramatic market changes imply that regulation is still a craft and not a science. We must make regulatory judgements every day, to ensure that the markets we supervise are resilient to shocks. To do our job properly, we must have the range of tools and judgement to use them effectively. But regulators are also human. We need to be independent but we are not independent of the environment in which we work. Our rules and regulations shape our environment and our environment shapes us.

We need to understand our environment, understand our strengths and weaknesses and what our role is in shaping the incentives structure in the financial system. No other job presents such formidable challenges. So, as a comfort to all young aspiring regulators in this Summer School, our craft may be tough, unpopular and thankless, but it is an important one.

Go home, pick important problems, fix them and tell everyone!

LAURA CHA

22

Regulatory Framework after the Merger of the Exchanges

Hong Kong Securities Institute Seminar
21 October 1999

Around October each year, the Securities and Futures Commission (SFC) undertakes to review our corporate plans in the context of the budgetary exercise for the next financial year. Last year, with lessons learned from the Asian financial crisis, the Commission took a critical look at the fundamental structure of our market and determined that major reform in several areas would be required in order to keep the Hong Kong market updated in the rapidly changing globalized markets. We were pleased to have the full support and encouragement of the Government, without which it would not be possible for us to put the proposed reforms on our work program.

In March this year, the financial market reform programs were announced by the Financial Secretary in his Budget Speech. I would like to take this occasion to give you a progress report on the three major reform projects of which the SFC has responsibility: first, the demutualization and merger of the Stock Exchange of Hong Kong (SEHK), the Hong Kong Futures Exchange (HKFE) and the three Clearing Houses; second, the Steering Committee on the Enhancement of Financial Infrastructure (SCEFI); and third, the consolidation of all securities-related legislation in the form of the Securities and Futures Composite Bill.[1]

The reasons and the urgent need for reforming the Hong Kong market have been well articulated in both the Budget Speech and the policy papers[2] issued at the time, and have since been explained by both the Government and the SFC on many occasions. No doubt you are all familiar with them and I will not repeat them here.

Let me now deal with each of the reform projects in turn.

eFrastructure

First, the enhancement of Hong Kong's financial infrastructure: our Chairman, Andrew Sheng, who chairs the Steering Committee, has already reported on the preliminary findings by this Committee last week. I will only summarize the key features of what Andrew called "efrastructure", the components of which include: single clearing arrangement, straight-through processing, scripless securities markets; and open, robust, and scalable technology structure. Each of these components has its own set of building blocks which are inter-related and will build on one another.

It is envisioned that the upgrade and enhancement of our financial infrastructure will enable us to accomplish our strategic objective of embracing state-of-the-art technology in order for Hong Kong to remain in the premier league of world financial centers, by enhancing the competitiveness of our market in terms of risk mitigation, efficiency improvement, and cost reduction.

To arrive at our destination, the Steering Committee has proposed the following initiatives to be completed within a 2-year time frame:

1. To implement consolidated account reporting;
2. To build a securities and derivatives community network (FinNet for securities clearing first);
3. To implement appropriate risk management;
4. To implement electronic filing for intermediaries on FinNet;
5. To upgrade securities clearing to open architecture;
6. To achieve single clearing arrangement;
7. To enable straight-through processing;
8. To consolidate derivatives clearing onto a single platform; and
9. To realize scripless securities market.

Many of these initiatives will need the collective efforts of the SFC and the new Exchange. With the support of the Government, we believe that our strategic objective is achievable in two to three years.

The Composite Bill

The second major reform that the SFC has been undertaking is the preparation of the Composite Securities and Futures Bill, which was started some years ago. The contents of the proposed Composite Bill would be the subject of a separate speech alone. In the interest of time, I would only outline the key features and leave the discussion for another day.

Eventually, the key features of the Composite Bill are:

1. Clarification of regulatory objectives of SFC;
2. Strengthened supervisory and investigative powers;
3. Civil fine based enforcement;
4. Market Misconduct Tribunal;
5. A streamlined licensing regime for market intermediaries and advisers;
6. New regulation on electronic trading; and
7. Expanded accountability and checks and balances for SFC decisions.

With regard to the clarification of our regulatory objectives, we realize that clear objectives constitute vision and purpose of our regulatory regime. We will therefore establish benchmarks for our performance; set the principles by which we exercise our powers; increase transparency and accountability to the public. At the same time, we will continue to maintain and promote fair, efficient, transparent and orderly securities, futures and related financial markets; promote public confidence in and understanding of the financial system, and secure appropriate degree of protection of investors in securities. In furtherance of our functions, we will continue our efforts in minimizing crime and misconduct and reduce systemic risks in the securities, futures and other related financial markets. Finally, in carrying out our functions, we will assist the Government in maintaining stability and integrity of the monetary and financial systems in Hong Kong.

It is currently intended that the draft Bill will be put to Legislative Council (LegCo) in December of this year and the Financial Affairs Panel has already formed a Sub-Committee to study our proposals.

Demutualization and Merger of the Exchanges and Clearing Houses

Now, let me turn to the focus of my subject today: the merger of the Exchanges and Clearing Houses. As you will all be aware, the demutualization and integration of Hong Kong's market operators i.e., the SEHK, HKFE and their respective clearing houses has recently been overwhelmingly endorsed by the members of the two Exchanges. A new holding company, Hong Kong Exchanges and Clearing Limited (HKEC)*, will be established and is expected to be listed on the Stock Exchange during the course of next year. I would like to explain the roles facing the SFC as regulator during and after the implementation of the merger.

Hong Kong is bringing its Exchanges and Clearing Houses up to date not a moment too soon. Over the last seven months since the Financial Secretary announced the merger of our market operators, the pace of change in the securities industry worldwide has been frenetic - even the New York Stock Exchange, the world's largest exchange, with over 1,300 members, has now bowed to competitive pressures and is moving rapidly towards demutualization. Surely it

* Upon the merger of the exchanges and clearing houses, Hong Kong Exchanges and Clearing Limited adopted the acronym HKEx.

would now be impossible to deny that the securities community has reached an implicit consensus that demutualization maximises efficiency incentives and is critical to the survival of international exchanges.

The SFC's Role in the Merger

Against the background of the challenges facing Hong Kong's market operators, and our proposals to address these by restructuring the market, let me describe the SFC's role in the merger/and the post-merger environment.

As the securities and futures market regulator, the SFC has been closely involved in the conception and implementation of this major reform. By assisting the Government in guiding the demutualization of the Exchanges and the proposed listing of HKEC, the SFC has ensured that regulatory concerns are addressed as the market restructure takes place. The SFC's overriding concerns lie in ensuring that the existing market structure continues to operate effectively during the period of transition, that the procedures to implement reform are fair and transparent and conducted in accordance with all applicable legislative and regulatory requirements and accepted principles of good corporate practice, and that the new market structure fully reflects the important public role to be performed by HKEC.

The SFC has also been closely involved with the Financial Services Bureau in the drafting of the Enabling Legislation which is required to implement some aspects of the merger. The draft Exchanges and Clearing Houses (Merger) Bill will make only those changes to the existing legislative framework as are required to provide for the new holding company structure to come into being and to introduce a regulatory framework to govern the new merged group. Among other things, the Merger Bill will introduce new legal personalities, such as "exchange participant" (in place of exchange "member" or "shareholder") and "recognised exchange holding company" and provide for their regulation; it will also convert the Stock Exchange's

Clearing House - HKSCC - from a company limited by guarantee to a company limited by shares. It will provide controls on the size of shareholdings in the holding company and on the transfer of shares in the subsidiaries. The drafting of the Merger Bill continues and is expected to be completed by the end of October and introduced into LegCo by the beginning of November. It is currently hoped that the Bill will be enacted by the end of January 2000.

Rationalization of the Regulatory Function in the Post-merger Environment

At the same time as being actively involved in the broad thrust of the merger transaction and in the drafting of the Enabling Legislation, the SFC has undertaken a review of the regulatory functions which are presently shared between the Exchanges and the SFC. The reforms to be implemented in the post-merger environment have been designed with a view to rationalizing the division of those functions, removing potential conflicts which are inherent in self-regulation, improving efficiency and reducing unnecessary regulatory burdens on market participants. There is presently an element of duplication in the performance of the regulatory function in Hong Kong which is undesirable and increases costs for issuers, investors and other market participants.

The review of regulatory functions focused on four main areas, namely market surveillance, intermediaries supervision, compensation arrangements and listing and corporate finance. A review of current regulatory functions shared with the Clearing Houses has also been undertaken but forms part of the initiative and separate timetable under the Steering Committee on the Enhancement of Financial Infrastructure, which I have already described. Separately, a revamp of the current compensation arrangement is being studied with the new HKEC and will take some time for an integrated proposal to be developed and implemented. Let me now turn briefly to the rationalization proposals concerning market surveillance, intermediaries supervision and listing/ corporate finance matters.

Market Surveillance

In relation to Market Surveillance within the Exchanges, it was decided that the division of functions would remain substantially as at present, albeit with clearer delineation and refinement of respective responsibilities in order to reduce current areas of overlap and inefficiency. The separation of functions between HKEC and the SFC would be formalized by the introduction of clear written procedures.

As a commercial organisation, HKEC's surveillance functions will be more business-oriented. Thus, its market surveillance unit will focus on trading operations and risk management, which include: (a) enforcement of trading and clearing rules and detection of trading malpractices by users (liaising with the SFC as necessary in relation to those malpractices which may involve statutory offences); (b) maintenance of market transparency by monitoring price and turnover movements on a real time basis and requiring prompt disclosure of price sensitive information; (c) assisting in the risk management process by monitoring exceptional concentrations in positions and unusual price fluctuations; (d) interaction with market participants, including handling of disputes in relation to trading matters; and (e) cross-market surveillance of HKEC's users.

With our wider statutory powers, the SFC, as the oversight regulator, will be primarily responsible for detecting market malpractices with statutory implications. The SFC's market surveillance activities would therefore include: (a) scrutinizing market activities to detect potential breaches of laws relating to the securities and futures market; (b) conducting investigations of possible statutory offences that fall within its jurisdiction, including those commenced on referrals from HKEC, other agencies and complaints from the public; and (c) overseeing the surveillance actions undertaken by HKEC and performing cross-market surveillance of activities between HKEC markets and Non-HKEC markets.

Intermediaries Supervision

In relation to Intermediaries Supervision, the functions currently performed by the Exchanges in the prudential regulation of their members would be moved to the SFC. However, HKEC would continue to monitor particular aspects of the business of intermediaries so that it may assess and manage the risks inherent in the operations of its subsidiary business units.

At present, the Exchanges are primarily responsible for the routine inspection of their members' businesses, for monitoring their compliance with trading and conduct rules and the liquid capital requirements, and for ensuring that their members have in place proper systems of management and control. The SFC, however, retains a shared responsibility for all of these matters and is often required to act in response to regulatory concerns, particularly where the necessary response extends beyond the scope of the Exchanges' authority. Transferring the primary responsibility for those matters to the SFC will remove duplication and overlap and ensure that a comprehensive response to regulatory issues can be made by the primary regulator.

This transfer of functions should also remove potential conflicts of interest which may arise in future between the Exchanges and those of their users which may decide to develop alternative trading systems which compete with those of the Exchanges.

Listing/Corporate Finance

In relation to Listing and Corporate Finance, the division of functions would remain substantially as at present, albeit with improvements in efficiency within the Stock Exchange's Listing Division and in the co-ordination of functions undertaken by both the SFC and the Stock

Exchange. This would necessarily involve a re-examination of the allocation of resources by both the Exchange's Listing Division and the SFC's Corporate Finance Division and an examination of our functions and work processes. The SFC contemplates entering into a new Memorandum of Understanding with HKEC which would clarify the standards to be met by the Stock Exchange in performing its functions in this area and provide for greater interaction between the two bodies.

Furthermore, and in order to remove the conflict of interest which would arise if the Stock Exchange were to supervise its own holding company, the Enabling Legislation will provide that the SFC will be responsible for all matters regarding HKEC which would, in the case of any other listed company, be dealt with by the Listing Division. Provisions will be included in the Merger Bill to provide for new listing rules allowing the SFC to "step into the shoes of" the Listing Division in relation to HKEC's own listing and its continuing compliance with the Stock Exchange's listing rules. The SFC may also need to assume the role of front line regulator more broadly in relation to other listed companies or exchange participants in all cases where it considers that the business interests of HKEC as a corporate entity may conflict with its subsidiaries' responsibilities as market regulators. This is likely to be the case, for example, whenever HKEC and any other Hong Kong listed company or exchange participant are competing for business and the resulting transactions require the performance of a regulatory function ordinarily performed by one of the HKEC group companies, such as a disclosure of information to the public under the listing rules requiring the involvement of the Listing Division of the Stock Exchange.

Staffing Needs

Many people have asked: what does regulatory rationalization mean to the organizations concerned? More importantly, what is the impact of rationalization on the staff of the two Exchanges and Clearing Houses?

I am pleased to report that over the last two months, we have worked closely with the management of the SEHK, HKFE and HKSCC to design a transition program which will both capture the skills and experience of the current staff of these three organizations and ensure the continuous smooth operation of the marketplace. We are also keen to ensure that regulatory functions would continue to be performed properly so that in the course of the transfer of function there will not be any gap or overlap.

With this in mind, the SFC has estimated that we would need to recruit approximately 50 new staff in the course of the next 12 months to carry out our expanded responsibilities. The new staff will be recruited in stages, with the first batch of 15 or so to commence shortly so that they could be in post by January 2000. We are eager to retain the experience of the existing staff of SEHK and HKFE and will therefore direct our efforts in recruiting our first batch of new staff solely from these three organizations. We have also agreed with the management of the Exchange that a combination of recruits as well as secondment will be put in place to facilitate the expedient transfer of functions as well as the smooth operation of the HKEC.

The positions and job specifications for the new posts will be provided to the Exchanges in the next week or so.

Evolution of the Regulatory Role into the Next Millennium

Considerable challenges are facing Hong Kong's securities and futures markets. The three reform programs I have described today are designed to meet such challenges head on.

In the coming year, the SFC will devote much resources in completing and implementing these three major market reforms. We recognize that much is on our plate and that we rely on the support of the Government to make it possible for us to complete our tasks. In this regard, I am pleased that the unity of purpose and the collective efforts of the Government, regulator and market participants in the last year have demonstrated that together we can indeed make our market better in the face of competition.

A modern and competitive market both requires and benefits from the presence of a focused, capable and respected regulator charged with maintaining market integrity and protecting investors. In order to discharge our statutory responsibilities, the SFC must keep abreast of market developments in Hong Kong and overseas; we must increasingly co-ordinate with regulators in other jurisdictions in order to facilitate and safeguard cross-border investment activities; and most importantly, we must be forward-looking and facilitative of change. Hong Kong has accepted the need to re-engineer its market institutions, infrastructure and securities regulations in order to participate and compete effectively in the increasingly complex and sophisticated global securities and futures markets. It must also ensure that it continues to have, and is seen to have, a world class regulator.

With the support of Government and the market the SFC is eager to develop our activities and skills base as necessary to ensure that we continue to provide Hong Kong with a world class regulator which will be a partner to our world class markets.

Postscript

The demutualisation of SEHK and HKFE, and the merger of these two exchanges and their associated clearing houses into a single holding company, HKEx, was completed on 6 March 2000. HKEx was listed on 27 June 2000. The Securities and Futures Ordinance was enacted in the Legislative Council on 13 March 2002.

Endnotes

1 Financial Services Bureau (1999), "Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre", July (Hong Kong Special Administrative Region Government).
Visit http://www.info.gov.hk/fsb/reinforc/index.htm

Report on the Enhancement of the Financial Infrastructure in Hong Kong: "An eFrastructure for a Leading eEconomy", prepared by the Steering Committee on the Enhancement of the Financial Infrastructure, September 1999.
See Publications - Others at http://www.hksfc.org.hk

For Consultation Papers on the Securities and Futures Bill, visit http://www.info.gov.hk/fsb/consult/index.htm and http://www.info.gov.hk/fsb/bill/index.htm

2 A Policy Paper on Securities and Futures Market Reform, March 1999, Government of the Hong Kong Special Administrative Region.
Visit http://www.info.gov.hk/fsb/security/sec_1.doc

Laura Cha

Securities Market Reform: the Hong Kong Experience

23

The Commonwealth Club of California
San Francisco, 6 June 2000

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

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

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

Hong Kong is far from being alone in such large-scale transformation. A survey conducted at the end of 1999 showed that 15 exchanges worldwide had already demutualized, 14 were about to do so, and another 15 were seriously contemplating it. Among those which have already demutualized are exchanges in Australia, Amsterdam, Frankfurt, Stockholm, Singapore, and Toronto. Of these, the Australian, Amsterdam and Stockholm Stock Exchanges have also become listed companies themselves.

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

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

The Forces of Change

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

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

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

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

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

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

The Need for Reform

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

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

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

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

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

The Hong Kong Experience

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

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

Given these dynamics and developments around the world, the Securities and Futures Commission, together with the Hong Kong Government, decided that the Hong Kong market needed to quickly reinvent itself in order to be a viable player in the global financial scene.

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

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

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

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

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

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

What will be the Future of the Securities Market?

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

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

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

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

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

Investors will be the ultimate beneficiaries of all these changes in the marketplace. Investors will have more choices and information on investment products, easier accessibility to any market they wish to trade on, and better and cheaper services from intermediaries. The new generation of investors will become increasingly sophisticated as market information becomes widely available. However, the complexity of the new markets also means that investors must know their own risk appetite before entering the market. With sophistication in the marketplace, the demand for improved corporate governance by public companies will also increase.

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

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

Mark Dickens

24 E-Commerce from a Regulator's Point of View

ISSA Symposium
Wolfsberg, 24 May 2000

I should like to thank the organizers of this Conference for the honour of inviting me to speak at Wolfsberg. I thank them especially for the opportunity to step back from the day-to-day hurly burly of regulating Internet brokers, alternative trading systems and electronic initial public offerings (IPOs) and trying to keep track of the bewildering range of alliances, joint ventures and linkages between exchanges and clearing houses that are being driven by e-commerce to try and focus on the longer term, more fundamental issues of where e-commerce is taking the art of regulation and what it means for the role of securities and futures regulators in the future. There is little consensus regulatory literature as yet and most of what there is relates to responses by particular regulators to particular problems that have already arisen in their jurisdictions, some of which appear to be unique to the US. Accordingly, the views I express about the more fundamental issues are tentative and my personal views, not those of the Securities and Futures Commission (SFC), and do not represent a common view amongst regulators.

At the risk of confirming your prejudices about regulators, I intend to focus on e-commerce's impact on the width of regulatory jurisdiction and on the manner in which it is exercised. At this level, it seems to me that e-commerce has four main effects. First, it brings about a very significant widening of jurisdiction and an increase in the relative authority of regulators at the national level. It does this partly by bringing the statutory regulators into a closer, more direct, and more equal relationship with retail investors; partly by giving regulators new areas of direct jurisdiction over intermediaries, whether firms, exchanges or clearing houses; and partly by increasing statutory regulators' authority and status relative to their historical partners in co-regulation - exchanges - and opening the possibility of new partnerships in regulation with new players. Secondly, because e-commerce transcends national boundaries, it forces regulators to evolve international regulatory networks to cope with greater cross-border co-operation and competition between exchanges, quasi-exchanges and clearing houses. Thirdly, partly because of increasing internationalization, partly because the increase in statutory regulators' jurisdiction is so great and partly because the rate of change in the securities and futures industry has been so greatly accelerated by e-commerce, regulators are forced to re-examine the traditional style of regulation. In my view, this implies a move away from reliance on detailed, black-letter rules to a style of regulation which specifies general principles and desired ends and outcomes and which leaves it to the industry to fill in the blanks in the light of evolving best practice. Fourthly, regulators need to understand that e-commerce has the potential to do a great deal of the regulators' work for them; by empowering retail investors increasingly to make their own self-directed investment decisions on the basis of much more easily accessible information and increasing the investment opportunities available to them, e-commerce has the ability to drive a "race to the top" in the quality of markets and of investor protection.

Before discussing these propositions in detail, I should put Hong Kong into context. Although Josef was very complimentary about Hong Kong's level of preparedness for e-commerce, Internet usage in the Hong Kong securities and futures industry is so far surprisingly low compared to the United States and other regional markets like Korea. Only about 20 of more than 500 brokers provide Internet broking and it accounts for only about 1% of stock market turnover. Despite this low level of penetration, Hong Kong stands out amongst developed market regulators in two aspects. First, in the Report of the Steering Committee on Enhancing the Financial Infrastructure, it has produced a publicly available high-level blue-print for exploiting on a market-wide basis the potential efficiencies e-commerce provides in relation to clearing, settlement and other back-office issues. The Report envisages a single clearing arrangement for cash and derivatives, a single integrated high-security network for the financial community, scripless markets and a path towards straight through processing.

Secondly, in its Guidance Note on Internet Regulation, the SFC has made it clear that Hong Kong residents are free to seek out and take advantage of financial services and products made available over the Internet and that the SFC will exercise jurisdiction over offshore service providers less aggressively than its international counterparts. Whilst this policy reflects the characteristics of Hong Kong as a geographically small but cosmopolitan international city, it also presents an opportunity to enhance investor choice, increase investor sophistication and drive the Hong Kong market to higher standards of disclosure, corporate governance and investor protection through increased competition and changing retail investor expectations. When local retail investors trade in overseas markets, they find higher standards in these areas and it becomes increasingly necessary for the local market to offer an overall package of proper disclosure and investor protection that matches best overseas practices - not merely for the sake of satisfying the expectations of foreign institutional investors but also to retain the local retail investor base.

A similar process of raising standards can be observed in all markets where retail investors are now trading more actively through the Internet. As retail investors become more sophisticated and self-directed, they are making new demands to which regulators, who have always regarded retail investors as their core constituency, have had to respond by eroding traditional franchises and privileges and facilitating increased competition. Examples from the US include the Securities and Exchange Commission's (SEC) initiatives in relation to Regulation ATS, Rule 390 of the New York Stock Exchange and market fragmentation in response to retail demand for better execution.

The increasing trend for retail investors to trade without human intermediation and advice is also leading statutory regulators to change their emphasis, to move away from reliance on mandating duties of proper advice on intermediaries and towards more direct communication with investors. Means of doing this include providing investors with material information over the Internet, such as via the SEC's EDGAR system or Hong Kong's Electronic Investor Resources Centre and increasing the transparency of regulatory activities by such means as "town meetings", enforcement "sweeps" and joint international action in relation to the "high-tech" phenomenon. The Financial Services Authority (FSA) is exploring the possibility of direct contact with investors at the point of decision by providing them with software that would automatically provide regulatory information and warnings when a financial services site is accessed, together with intelligent hyperlinks to other sites where investors could obtain additional information to assist in decision-making.

But the widening of the regulators' role in this way does not imply a reduction in the obligations they impose on intermediaries but rather the reverse. Regulators are not saying that, because investors have more information and autonomy, regulators will relax intermediaries' obligations to "know the client" and provide "suitable advice"; rather they are considering extending these obligations to cover the new forms of interaction with clients that e-commerce makes possible. The SEC, for example, is considering the circumstances in which these obligations apply as a result of the use of data-mining to profile investors and present them with information and investment alternatives that are to some degree customized. Similarly, regulators in Australia and Hong Kong are considering the ways in which Internet brokers should discharge their duties of due skill, care and diligence towards the integrity of the market in relation to possible market misconduct or insider trading.

In a further development, regulators are tending to extend their jurisdiction over e-commerce by extending the general concept that an intermediary must be "fit and proper" to impose requirements on e-business that were not explicitly applied to non-electronic business. For example, they are requiring the maintenance of adequate capacity, security and contingency plans and requiring investors be given warnings of the disadvantages of technology such as possible delays and outages. By a natural progression, regulators have now begun to review not only the fairness and transparency of market operators' trading systems but also their capacity, robustness, scalability, security and functionality.

Paralleling this tendency to regulate more about regulatees' businesses has been a trend for statutory regulators to regulate intermediaries directly in areas in which they were previously regulated indirectly through Self-Regulatory Organizations (SROs) or exchanges. This trend is most pronounced where exchanges have demutualized and abandoned or lost most of their previous SRO role. In Hong Kong, for example, although the demutualized exchange retains the ability to enforce its trading rules and manage its business risks from market participants, it is in the process of transferring to the SFC its previous front-line role in regulating intermediaries' conduct towards clients and is becoming dependent on the statutory regulator to provide it with information it previously gathered directly from its members. In Australia and Hong Kong the Exchanges have also lost aspects of listing regulation to the statutory regulators - in relation to the regulation of their own listings and where there are possible conflicts of interest in regulating the listings of business partners or competitors. Both regulators felt they should stop there, since it is an open question whether a profit-making exchange would have an adequate core business without the ability to brand itself through its administration of listings, but it is interesting that the UK has now gone one step further, with the London Stock Exchange (LSE) totally relinquishing its listing authority role to the FSA.

Whilst more direct regulation by the statutory regulators rather than an exchange or SRO has the advantages that it is backed by statute and is less likely to be perceived as cosy and self-interested, it cannot be cross-subsidized out of the business operations of the Exchange as it previously was and becomes subject to public sector resource constraints. Accordingly, the style of regulation has to become risk-based and the regulators have to rely largely on guidance. In addition, to cope with the higher pace of change in the industry, the style of regulation has to be flexible. These considerations imply the delegation of more rule-making power to the regulator by the legislature and also imply that the regulator should rely as much as practicable on high-level General Principles rather than on detailed black-letter rules to guide conduct.

Another consequence of exchanges losing much of their historical self-regulatory role is a change in the nature of the special relationship they previously enjoyed with the statutory regulators and governments, as they become more obviously businesses subject to regulation rather than partners in regulation. This reduces the ability of exchanges to protect their historical franchises and privileges and those of their members and, particularly where there is competition or the threat of competition from electronic communications networks (ECNs), presents the statutory regulator with opportunities to outflank industry vested interests previously unified behind the exchanges. But the regulator also loses the ability to engage with the industry through a single organ and foregoes all of the benefits for itself and the industry of modulating its regulation of the industry by transmitting regulation through an industry body. Except possibly in the US, it seems unlikely that industry-wide SROs will evolve to fill this gap; pure unsubsidized self-regulation is expensive and the interests of industry participants are diverging rather than converging under the influence of e-commerce. In this connexion, it is noteworthy that regulators are beginning, for a number of reasons, to focus more closely on their relationship with the operators of clearing and settlement systems, with whom all industry participants must have a direct or indirect relationship. Whilst at present this focus is driven primarily by risk management concerns, I do not think it is fanciful to envisage settlement system operators becoming the new partners of the statutory regulators in co-regulation of the industry.

The trends discussed above all relate to the ways in which e-commerce is leading to a widening of statutory regulators' roles and a strengthening of their status relative to market participants, with the major benefits being a greater responsiveness by regulators to the needs of retail investors and, in the longer term, the adoption of a more flexible style of regulation. I now turn to discuss an aspect of e-commerce that appears likely to undermine the effectiveness of statutory regulators but which I believe will in practice reinforce the trends towards greater flexibility and higher levels of investor protection. E-commerce is essentially borderless whilst the jurisdiction of securities regulators stops at the border.

A decade ago, the territorial limitations of securities regulators were not all that important. International activities were restricted to isolated examples of cross-border misconduct, such as insider trading and fraud, a small number of global IPOs and the trans-national activities of several intermediaries who were not particularly important outside their home markets. Now, in contrast, regulators are faced with a situation where their domestic retail investors potentially have desktop or palmtop access to all aspects of all markets, national regulators find themselves dealing with a handful of dominant global investment banks who have relationships with up to 150 regulators and demand consistency of regulation between them, and market operators straddle national boundaries.

At retail level, the initial regulatory reaction has been to attempt to assert national jurisdiction over offshore service providers and offshore offers of securities that are available to local investors, even where the services or offers are only passively available. Many national regulators have interpreted their national legislation in such a way as to effectively oblige offshore service providers to take active steps to exclude access to their services. It is doubtful whether this approach is sustainable beyond the short term. Except in the largest markets it presents considerable practicable difficulties of enforcement. Despite the existence of memoranda of understanding providing for mutual assistance in enforcement between national regulators, resource constraints limit the amount of co-operation practically available from one regulator to another except in cases of serious misconduct; it is simply unrealistic to expect a national regulator to devote significant resources to enforcing the licensing regime of another jurisdiction simply because a national in the second jurisdiction has used the services of a licensed intermediary in the first. More importantly, such restrictive policies deny investor choice and restrict competition; they attempt to limit the way in which the Internet empowers retail investors to make informed investment decisions to access other markets. Recently, signs have emerged in speeches by regulators in the leading developed markets that they are beginning to realize the impracticability of a restrictive approach that attempts to limit investor choice and to acknowledge that their markets will in practice become more open.

The implication is that national regulators will have to increase the level of international co-operation and show an increased willingness to rely on the integrity and effectiveness of foreign regulatory systems in deciding whether and how to assert national jurisdiction. Except within the EU, this is unlikely to take place through the adoption of a formal system of mutual recognition by one authority of another, since there are considerable institutional impediments to such an approach. In many jurisdictions, the law does not provide adequately for mutual recognition; there are issues of accountability to national legislatures and there are significant trust issues in regulators agreeing to rely on the competence and effectiveness of their foreign counterparts.

Nevertheless, regulators face an immediate need to come up with practical solutions to the issues posed by cross-border market operators and market participants and, under the pressure of necessity and without a great deal of theoretical analysis, what seems to be evolving is an international regulatory system with two main elements.

The first is a sort of spaghetti model of multiple bilateral co-operative arrangements on particular topics and in relation to particular regulatees. The individual arrangements are tantamount to limited *de facto* mutual recognition subject to the safeguard that national jurisdiction can be asserted if necessary. A very small example is the Pilot Program under which selected NASDAQ stocks are traded on the Stock Exchange of Hong Kong. Hong Kong has no nexus with the issuers; the issuers have not signed listing agreements and are not subject to Hong Kong listing rules or disclosure standards and only those provisions of Hong Kong's securities legislation that prohibit market manipulation apply. The SFC made the pragmatic decision that, at least in relation to selected issuers, it was content to rely on the US regulatory system and the effectiveness of the SEC as providing adequate protection to Hong Kong investors. At a more systematic level, IOSCO[1] Working Party No. 2 is developing principles to guide the co-ordination of regulation when a market operator straddles more than one jurisdiction.

The second element is greater harmonization of regulatory content and practice between jurisdictions. This has become the major work of IOSCO and similar bodies and, especially since the process of international standard-setting was accelerated by a number of inter-Governmental initiatives following the Asian financial crisis, standards promulgated by bodies such as IOSCO are increasingly taking on a level of normative force. Given the wide variations in the characteristics of national markets and in their legal frameworks, harmonized standards can only be agreed at the level of broad general principles rather than detailed rules. Increasingly, national regulators are finding it convenient to incorporate these principles directly into their rules, sometimes using them to replace or to re-systematize the detailed rules they previously used. Whilst this increases the standardization of the content of regulation between different jurisdictions and facilitates international commerce, there remains a significant risk of disuniformity of administration and consequent uncertainty and cost for business. Regulators at the national level can reduce the risk of disuniformity by making a conscious effort to consult international industry bodies such as ISSA[2], IPMA[3] and ISDA[4] in formulating their administrative approaches to ensure that they are consistent with, and accommodate, international best business practice.

[1] IOSCO: International Organization of Securities Commissions
[2] ISSA: International Securities Services Association
[3] IPMA: International Primary Market Association
[4] ISDA: International Swaps and Derivatives Association

Despite occasional reservations voiced by some national regulators, I do not believe that the development of harmonized and linked regulation carries a significant threat of lower standards or of regulatory arbitrage. Experience so far shows that the tendency is to level regulatory standards up rather than down and the dynamics of international e-commerce seem likely to reinforce this tendency. As every market's technology becomes comparable, as liquidity forms larger pools, and as investors come to regard offshore investing as natural as domestic investing, I believe markets will seek to brand themselves by offering an increasingly global retail investor base and global intermediaries higher quality disclosure, corporate governance and investor protection, greater efficiency in processing transactions and greater flexibility and clarity of regulation. If this is correct, then the development of e-commerce in the securities and futures industries is likely to lead to the better attainment of the goals of regulation: investor protection, market integrity and reduced systemic risk - without imposing undue burdens on industry.

Paul Bailey

Enforcement Philosophy of the Securities and Futures Commission

25

August 2001

Introduction

Public images about the Securities and Futures Commission (SFC) enforcement actions are often influenced by press stories, which can sometimes distort the public's perception of the SFC's role and its actions. The reality is more complex and often less dramatic.

The purpose of this paper is to provide an overview of the SFC's enforcement philosophy: why the SFC takes enforcement action, what enforcement powers it has, how it exercises those powers, and the principles that guide its enforcement action.

We hope this paper will help to dispel some of the misconceptions that there may be about how the SFC enforces relevant laws and standards.

Why the SFC Takes Enforcement Action

Hong Kong's securities and futures markets are the second largest in Asia outside Japan, and are widely considered the most international in Asia. One of the most crucial factors in Hong Kong's ability to attain and maintain this position is that its markets are generally seen as fair and efficient, so investors and market participants have confidence in them. One of the important factors behind this is that the laws and standards governing our markets have been rigorously and credibly enforced.

Of course, most market participants, in the SFC's experience, want to (and do) comply with the law and relevant business and professional standards. But, unfortunately, there is a minority that, for whatever reason, fails to do so. To deal with the actions of this minority, there is an obvious need for an appropriate authority to act in the public interest, with the power to take necessary steps to try and ensure that:

- the actions of the minority do not cause potential loss to the investing public, or disrupt the securities and futures markets; and
- the persons responsible for wrongdoing are held accountable for their actions.

The SFC's Power to Take Enforcement Action

The SFC's responsibilities

Section 4 of the Securities and Futures Commission Ordinance (Cap. 24) sets out the SFC's functions as mandated by the Legislative Council.

Among the SFC's roles are enforcing the laws governing the securities and futures markets, and taking action to suppress illegal and certain improper or unethical conduct in those markets. For example, it is required to:

- ensure that there is proper compliance with the laws that it administers;
- report suspected insider dealing to the Financial Secretary for possible referral to the Insider Dealing Tribunal;
- take whatever other lawful action it considers appropriate to suppress illegal, improper or unethical conduct in the securities and futures markets and in trading in other financial products it regulates; and

- co-operate with local, national and overseas regulatory and law enforcement agencies (which would include enforcement issues).

The SFC's statutory powers

The SFC has extensive statutory powers so that it can perform its enforcement responsibilities. These include the power to:

- require a listed company or its group companies to produce documents where it appears to the SFC that, for example, the company's business has been carried on with intent to defraud its creditors, or for a fraudulent or unlawful purpose;
- require details of transactions in securities, futures contracts, property investment arrangements or leveraged foreign exchange trading;
- direct one or more people, usually SFC staff, to investigate any matter where the SFC has reason to believe, for example, an offence under any of the laws it administers may have been committed, or where insider dealing may have taken place. Once appointed an investigator can then require any person he reasonably believes or suspects of having in his or her possession or control any document which contains or is likely to contain information relevant to a lawful investigation to:
  (a) produce the document;
  (b) explain the document;
  (c) answer SFC questions in an interview; and
  (d) give the SFC all reasonable assistance in relation to its investigation;
- execute search warrants and seize documents relevant to a lawful investigation or a listed company inquiry subject to a successful application for a warrant before a Magistrate;

- report suspected insider dealing to the Financial Secretary for a possible referral to the Insider Dealing Tribunal;
- report suspected serious crime to the Department of Justice for possible criminal prosecution on indictment and/or to the Hong Kong Police or Independent Commission Against Corruption (ICAC) for further criminal investigation;
- prosecute in its own name any relevant summary offences under the legislation that it administers;
- institute disciplinary proceedings against registered or licensed persons for misconduct or not being fit and proper which may lead to a reprimand or a suspension or revocation of their registration or licence;
- apply to the Court of First Instance (CFI) for an order to remedy unfair prejudice to the interests of members of a listed company after consulting with the Financial Secretary;
- direct the stock exchange to suspend dealing in a listed security;
- issue various notices restricting a registered or licensed person's ability to deal with assets, restricting their business or requiring them to maintain certain assets in or outside Hong Kong;
- apply to the CFI for an order to wind up a company or licensed leveraged foreign exchange trader where it appears to the SFC to be expedient in the public interest to do so;
- apply for a bankruptcy order against a registered or licensed individual where it appears to the SFC to be expedient in the public interest to do so;
- apply to the CFI for an injunction restraining an actual or apprehended breach of a restriction notice, the Financial Resources Rules or, under the Leveraged Foreign Exchange Trading Ordinance (LFETO), a requirement in connection with a winding up or bankruptcy order for a licensee;
- apply to the CFI for various orders in relation to an actual or apprehended breach of the Securities Ordinance (SO) or LFETO (or subsidiary legislation made under the LFETO) or a condition of registration under the SO or a condition of a licence under the LFETO; and

- take disciplinary action before the Takeovers and Mergers Panel (in the form of the Takeovers and Mergers Executive) for a breach of the Hong Kong Code on Takeovers and Mergers or the Share Repurchases Code.

How the SFC Exercises its Enforcement Powers

The enforcement process

The process of enforcing relevant laws and regulations generally involves two main steps:

- identifying that a breach of the relevant laws or regulations has taken place, and those responsible for the breach; and
- taking necessary steps to protect the public interest and, if appropriate, to punish those responsible for the breach.

This process of enforcement is generally the responsibility of the SFC's Enforcement Division.

Identifying a breach of the relevant laws or regulations

The SFC does a number of things with a view to identifying whether or not there might be a breach of the relevant laws or regulations, and those who might be responsible. These include:

- carrying out market surveillance to see whether there is evidence of possible market misconduct (e.g. market manipulation or insider dealing);
- considering complaints from the public;
- considering referrals from the SFC's other divisions (Intermediaries and Investment Products, Corporate Finance and Supervision of Markets); and
- considering referrals from other organizations (e.g. the Hong Kong Police, the ICAC, or overseas regulators).

Investigations and inquiries: the SFC's role as an investigator

If the SFC reasonably suspects that there has been a breach of relevant laws or standards, it will conduct further investigations or inquiries to try and find out what has happened, and whether there is evidence of wrongdoing.

If it believes that a serious criminal offence may have been committed, it will refer the matter to the Department of Justice for prosecution on indictment and/or, for example, the Hong Kong Police or the ICAC for further investigation.

Taking steps to protect the public and punish wrongdoers

If, following its investigations or inquiries, the SFC finds sufficient evidence of wrongdoing, it may take whatever lawful steps it considers appropriate to protect the investing public. For example, it may apply to the Court for an injunction to restrain the wrongdoing.

If it is appropriate, it may also take action to punish the wrongdoers. In this context, the SFC may take disciplinary action against them, if they are registered or licensed intermediaries. Such disciplinary action may result in the suspension or revocation of their licences or registrations, or issuing reprimands.

The SFC also has the power to prosecute certain, less serious offences before the Magistrates' Court. These offences include, for example, unregistered dealing or advising on investments.

The SFC's enforcement principles

A number of important principles guide the SFC when considering and taking enforcement action. These start with the SFC's principal aims when taking or considering any enforcement action, and general principles that it looks to when seeking to achieve these aims.

What are the SFC's enforcement-related aims?

The SFC's key enforcement-related aims are to:

- **protect investors (and the public interest)**. The SFC will take whatever lawful action it considers appropriate or necessary in the circumstances to protect investors and the interests of the public; and
- **maintain market integrity**. The SFC will take whatever lawful action it considers appropriate or necessary in the circumstances to maintain market integrity and confidence.

These aims are derived from the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions.[1] The SFC will keep these aims in mind when considering what enforcement action (if any) it should pursue in the circumstances.

Principles guiding the SFC's enforcement-related action

- **Stopping things before they happen**. The SFC believes it is better to stop improper conduct before it happens, or, if it has happened, stop it from continuing than to remedy it after the fact. In promoting the concept of prevention, we generally encourage intermediaries to foster a culture of compliance, and the investing public to learn about how they may do more to look after their own rights and interests.
- **Remedying what has happened**. If wrongdoing has already occurred, the SFC will take appropriate steps to try and remedy it. We will look at each situation in light of its particular

[1] The Objectives and Principles contain three objectives of securities regulation: protecting investors; ensuring markets are fair, efficient and transparent (market integrity); and reducing systemic risk. As some of these objectives are more relevant to the regulatory process of which enforcement action is only a part, we have only referred to protecting investors and maintaining market integrity. The Objectives and Principles are available at http://www.iosco.org

circumstances and consider what might be appropriate courses of action, keeping in mind the interests of the investing public.

It is important to note that, although the SFC is required to act in the public interest, it cannot itself seek compensation for those who have suffered loss as a result of wrongdoing, or directly assist them in their attempts to seek compensation through the Courts.

- **Punishing wrongdoers and deterring potential future wrongdoing.** Generally speaking, punishment is usually appropriate or necessary for those who have engaged, or tried to engage, in wrongdoing. Punishment serves a number of purposes. Perhaps the most important of these is that it generally deters wrongdoers from engaging in further wrongdoing. And it may also deter others from engaging in wrongdoing.

  To try and maximise the deterrent effect, the SFC will generally publicise its actions, wherever appropriate, to make clear that those who engage in crime or improper conduct run the risk of being caught and punished.

Principles guiding the SFC's enforcement-related decisions

- **Firmness.** The SFC will make firm decisions, and it will stand firm if it believes it is appropriate to do so in the public interest.
- **Fairness.** The SFC will act fairly. It will seek to comply with all applicable professional standards, and statutory and common law standards of procedural fairness.
- **Consistency.** The SFC will try to ensure that any enforcement action it takes is generally consistent with past action taken. However, the SFC will consider each case in light of its specific facts and circumstances.
- **Proportionality.** The SFC will take enforcement action that is proportionate with the wrongdoing in question, the consequences of the wrongdoing, and the extent to which the person who engaged in the wrongdoing is blameworthy.

For example, in some instances, it may be inappropriate to take very severe action against someone that has inadvertently breached a requirement, but has caused very little or no loss to others. Conversely, it would generally be inappropriate to treat leniently deliberately criminal or otherwise blameworthy conduct that causes significant loss to investors.

- **Openness.** The SFC believes in open dialogue, wherever possible. To the extent that the law and the public interest allow, and if it believes it is appropriate to do so, the SFC may negotiate a settlement. This can sometimes resolve matters more quickly allowing more efficient use of the SFC's resources.

  The SFC cannot represent or bind other bodies which may have an interest in the matter. In particular, the Department of Justice remains responsible for criminal prosecutions within Hong Kong and has the right to intervene in the SFC's conduct of summary prosecutions. The SFC will, where necessary or appropriate, consult such bodies when conducting settlement negotiations.
- **Effectiveness of action.** The SFC has limited resources on which there are many competing demands, and it has to make the best use of these resources. The SFC cannot do everything and must set priorities. By necessity, therefore, it will generally consider the costs and benefits of any action that it proposes to take, in light of its key aims and principles. Sometimes, this may mean that the SFC takes no action in relation to one matter (for example, where the SFC believes there has been a technical breach, which is unlikely to be repeated and has resulted in very little or no loss to investors) in favour of taking action in other, more important circumstances.

Co-operation with other regulators

- **Co-operating with other domestic regulators.** Sometimes it may be more appropriate for a regulatory body other than the SFC to take action. Where this is the case, the SFC will do what it can to co-operate with other regulators.

The Hong Kong Monetary Authority, the Insurance Authority or the Mandatory Provident Fund Schemes Authority all have certain responsibilities for regulating certain activities in connection with Hong Kong's securities and futures markets. In addition, the Hong Kong Police, the ICAC and the Department of Justice are responsible for dealing with serious crime. As far as it is legally able and it is appropriate to do so in the circumstances, the SFC generally co-operates with these bodies to ensure proper conduct in the securities and futures markets, and to suppress financial crime and misconduct.

- **Co-operating with Mainland and overseas regulators.** Given that borders are quickly losing their meaning, the SFC also co-operates with regulators around the world, including its Mainland counterparts. Whenever it co-operates, it does so within the law, and often through agreements called "memoranda of understanding". Under these agreements, the SFC and non-local regulators agree to assist each other in relation to certain matters, provided certain requirements, both legal and non-legal, are met.

Conclusion

Each of the SFC's enforcement actions involves a careful balancing of a number of complex issues. These issues vary from case to case. In balancing them and making a decision, the SFC will always endeavour to act firmly, fairly, impartially, keeping in mind the main guiding principles and aims described here.

CHARLES LEE

The Outlook for Exchanges in the 21st Century

26

Asian Securities Analysts Federation Annual Conference
Asia - The Third Global Financial Zone
Hong Kong, 3 December 2001

Today's Challenging Market Environment

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

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

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

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

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

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

Hong Kong's Response to Today's Challenges

Creation of HKEx

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

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

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

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

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

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

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

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

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

Greater market transparency and efficiency

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

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

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

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

Corporate Governance Standards

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Competition

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

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

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

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

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

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

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

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

Globalisation Trends/Challenges

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

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

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

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

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

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

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

Industry Leadership

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

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

The initiatives have included:

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

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

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

Conclusion

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

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

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

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

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

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

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

Edgar Cheng

China's Horse in a Global Race - Positioning the Hong Kong Securities Market[1]

27

August 1998

Despite the armies of economic and financial analysts who surround us today, the forces which cause financial centres to evolve or dissolve still preserve some of their mystery. The emergence of Hong Kong as a major international financial centre in the past 20 years was not the result of far-sighted planning. Nor was it just an accident. It was a product of market forces within a certain administrative, cultural, geographic and historical framework. The result is a world-class financial centre which can reasonably claim to be the most sophisticated, and certainly the most international, in Asia.

Some of the lustre has come off this pearl in the last 12 months as a result of the financial whirlwind which has swept through Asia. Although Hong Kong avoided the mistakes in economic and financial management which afflicted some other Asian economies, it has nevertheless been deeply affected by the turmoil. In the global financial marketplace, the importance of Asia as a whole has diminished.

At such a time, it may seem idle to talk about any Asian horse in the global race between financial centres. Such a perception would, in my view, be inappropriate. The present depressed state of Asia's financial markets should not cause us to lose sight of longer-term trends in the evolution of global markets, which I do not believe have

[1] An unpublished paper by Edgar Cheng.

suddenly veered off in a new direction. The East and South-east Asian emerging economies which grew at unprecedented rates for most of the past 20 years have not lost the basic ingredients which stimulated that growth. The weaknesses in their financial market infrastructure which were a prime cause of their recent setback are in most cases being steadily corrected. Whether it takes one or two or three years for these countries to get back onto that growth trajectory, it will happen. At that time, their equity markets will recover. As these economies mature, their rate of growth may slow, but most of them will still out-pace the major economies of Europe and North America for many years yet. And one side-effect of the recent turmoil is that, within Asia, the relative weight of Mainland China, Hong Kong and Taiwan has become greater than before.

If this long-term prognosis is correct (and I believe it is) the balance in financial market terms between Asia and the rest of the world will be restored. Indeed the relative position of Asia, and particularly China, will grow again. I therefore make no apology for maintaining the optimism which is reflected in many of my past speeches about the potential for continued growth in the role of Hong Kong as an international financial centre.

Taking a trip backwards in history, I am sure nothing could have been further from the minds of the British adventurers who prised Hong Kong away from China in the last century than the thought that they were preparing the ground for one of the global financial centres of the 21st century. Even 30 years ago, such a concept would have seemed fanciful to Hong Kong's administrators. It was only in the 1970s that Hong Kong started to gather momentum as an international financial centre. The principal catalyst for this development was the openness of Hong Kong's markets to banks, brokers, fund managers and other participants from anywhere in the world, at a time when most other Asian centres were to a greater or lesser extent closed or tied up in bureaucratic red tape. This openness was supported by a legal and administrative framework which was generally seen to be fair and objective. The expansion of Hong Kong's markets was of course fuelled also by rapid growth in Hong Kong's real economy, accelerated by even more rapid development on the Mainland in the 1980s and 1990s, unleashed by the "open-door" policies of Deng Xiaoping. Initially, the Hong Kong financial community was largely British, but in the last 20 years or so it has become highly cosmopolitan and a large body of local expertise has built up in most branches of financial services.

The institutional framework has nevertheless remained largely as constructed by the previous Administration.

Now Hong Kong is firmly launched as part of China. Can, and should, the framework remain the same?

So far it does not look much different on the surface. Despite the conditions created by the Asian financial crisis, the "One Country, Two Systems" formula has so far operated almost exactly as it was intended to do. Interference from Mainland authorities has been conspicuous by its absence. Hong Kong people are really running Hong Kong. And, at least in the securities market area, they appear to be maintaining the system much as it was before.

Therein lies a danger. Not because the system set up in colonial days was wrong at the time. But because it is wrong now in many important respects. This is only in part due to Hong Kong's reunification with China. The main reason the system is in need of overhaul now is that the international context within which our market operates has changed substantially, and we have not yet adjusted to this.

In retrospect, the main risk to Hong Kong associated with the Handover was never subversion of the courts or curtailment of individual freedom. It was inertia in the area of public policy, flowing from an understandable desire to avoid doing anything which might "rock the boat" during the delicate transition period. Despite some admirable initiatives, such as the formation and subsequent operation of the Hong Kong Monetary Authority and the earlier establishment of the Securities and Futures Commission (SFC), there was an evident reluctance to address some longer-term strategic issues in the securities market area or to pursue initiatives to up-date Hong Kong's institutions or legislation which might have provoked controversy. Here I must share the blame (if that is the right word) with Government, SFC and others, having been at the helm of the Stock Exchange for much of the relevant period. The harsh fact is, that, within the consensual society that we still are, fundamental changes of the kind necessary were simply not "practical politics" at that particular time. This period of partial paralysis co-incided with a time when changes in securities and derivative markets world-wide were accelerating, driven by technology and globalisation, and competition between financial centres was intensifying.

I do not claim to be an economic guru. There are, however, certain trends in the evolution of financial centres globally which have been growing for some time and are now obvious.

The first of these is that a multiplicity of "national" financial centres is steadily giving way to a handful of international centres. National boundaries are becoming increasingly irrelevant as the horizons of banks, investors, issuers and intermediaries become global. This is leading financial market activity to concentrate in the hands of a limited number of global firms and (importantly for Hong Kong) a limited number of global financial centres. What happens over the next few years is likely to determine which cities are the winners in this global race.

The second obvious trend is that electronic markets and electronic proof of ownership are making physical markets obsolete. They are also one of the factors causing markets to transcend national boundaries. Stock or futures exchanges (especially if they get caught in a "national" time-warp) will find their markets eaten away from under them by border-hopping trading systems, whether operated by other exchanges or global securities houses or information vendors or via the Internet. This process will be accelerated if exchanges cling to outdated practices such as fixed commissions, or if governments cling to forms of taxation which inhibit international competitiveness, such as stamp duty on securities transactions. Cost and efficiency determine where the business flows to. The time zone factor no longer restricts the direction from which the competition comes, as banks and dealers operate on a 24-hour-a-day basis from a single centre.

A third trend is that financial services have become a vastly more complex, competitive and sophisticated business. Commercial bankers are finding their traditional lending role usurped by securities markets. The role of simply being a stockbroker is becoming obsolete; value has to be added in some additional way to justify charging commission. Retail investors are giving way to institutions (many of them managing the collectivised funds of individuals) who pursue more complex and sophisticated investment strategies. The range and complexity of financial products increases by the day - securitisation of a wide variety of assets or cash flows; multitudinous forms of swaps; futures and options on equity, fixed income and commodity markets; "structured products" and "synthetic" securities - a vast array of instruments designed for taking or managing risk in innumerable forms. Much of this technology emanates from the USA or (to a lesser extent) Europe. Only a small part originates in Asia.

A fourth trend is that governments the world over are opening and deregulating their financial markets to make their economies more efficient and their financial centres more competitive. The recent financial crisis has accelerated this trend in Asia. Thus, one of the factors which differentiated Hong Kong from other Asian markets in the past (its openness and relative freedom from red tape) no longer represents such a competitive advantage as it did before.

It might be thought that technology, globalisation and deregulation would make the whole concept of financial centres obsolete - that investors and traders would no longer need to come to markets any more, because computers can take markets to them. But this is not what is so far happening. In practice, financial firms are continuing to congregate in a diminishing number of centres.

Why should this be? I believe the most important reason is that practitioners and firms who provide "high-tech" financial products and services thrive best when surrounded by other professionals in the same and related lines of business, with plentiful supporting professional service providers such as lawyers, accountants and IT providers. Markets thrive on innovation; innovation occurs where there are a large number of creative and intelligent people with common or inter-related skills interacting with each other under the pressure of competition. The life-blood of such a community is information. To the extent that networked computers can transmit more information faster from further afield, those who use it are able to stay in one place - the place they find most efficient, stimulating, congenial and cost-competitive. Thus, once a sufficient "critical mass" of financial market professionals has been created, it tends to increase in size due to its own gravitational force. But, if this process goes into reverse, a financial centre can disintegrate rapidly as the gravity of other centres tears pieces off it.

The increasing sophistication of financial products and services is contributing to this concentration of financial centres. Small firms are being driven to specialise and big firms to organise themselves along product, rather than geographic, lines. The product is generally managed from a global centre where the product expertise (including risk management capability) is concentrated. The financial centres which accumulate such product expertise become the hubs of the global market. Geographic units may still be needed by the product manager to help him reach his clients, but the product centre is the real "brain" of the business and, as communications improve, geographical outlets will tend to become leaner.

The product-driven focus of international securities firms is accentuated by the tendency of global investors to look at sectors or industries on a world-wide basis, rather than at geographical divisions of the market.

A key factor influencing the development of such global "hubs" is the supply available in the local labour market of individuals with the educational background, training and experience to contribute to the process of product development and management. Experienced and creative individuals may be routinely poached by one firm from another, but they tend to stay in a centre where they can remain at the forefront of financial market technology.

Another factor with a major effect historically on the evolution of financial centres is the size of the "home" market enjoyed by a particular centre. If demand in the domestic market is large and sophisticated, the firms that meet that demand develop the skills and economies of scale to become highly competitive in international markets. This is one of the main reasons for the increasing domination of world markets by firms with a strong base in North America.

Moving to the world of stock and futures exchanges, there are certain other global trends which have been evident for several years but have gathered pace recently.

The first of these is that exchanges, which originated as "clubs" of brokers with rules designed to protect the interests of their members, are having to become businesses operating in a competitive environment, responding to the needs of their clients (investors and listed companies). There is an inherent conflict between the interests of the organisation as a business (to provide cost-competitive, innovative services) and the interests of many of its members (to preserve restrictive pricing or trading practices and to limit competition). This conflict lies at the heart of the recent strategic malaise of both the London Stock Exchange (LSE) and the London International Financial Futures Exchange (LIFFE). Exchanges with less of a historical incubus, such as the Deutsche Borse in Frankfurt, have found it easier to adopt a modern governance and management structure. This has enabled them to set and maintain competitive corporate strategies. The need to do this has led numerous exchanges in Europe (such as the French MATIF, the Amsterdam, Stockholm and Milan stock exchanges) and further afield (including Australia) to "demutualise" - i.e. to separate ownership and management of the exchange from trading rights.

Facilitated by this process is another trend, which has become apparent more recently, towards mergers between derivative exchanges and those which operate the cash market. Factors driving this trend include the need to offer integrated services to clients (including cross-margining facilities) and efficiency gains in clearing and settlement. Such mergers have been particularly prevalent in Europe - for example in the Netherlands, France, Germany, Sweden, Austria and Switzerland, all fairly recently. Malaysia has also just merged its stock and equity futures exchanges.

A third trend in stock and derivative exchange organisation is now emerging forcefully - cross-border consolidation of exchanges. This process had already started (inter alia) between Frankfurt and Paris, when it was dramatically accelerated by the recent link-up between the London and Frankfurt stock exchanges. Stockholm and Copenhagen had already agreed to merge before all this. Numerous "alliances" had also been formed between exchanges in Europe, with a view to expanding remote membership.

What were and are the implications of these various global trends for Hong Kong? What is it that we need to change in order to remain competitive as a financial centre?

First and foremost, we have to maintain and increase Hong Kong's "critical mass" of sophisticated professionals. Here the Asian financial crisis has hurt us. Hong Kong may have retained or improved its relative position within Asia but, in the global context, Asia has become a less important part of the world. There has been some consequent outflow of expatriate personnel, in fields where financial market activity has declined. But, generally speaking, such fields are those of the more "plain vanilla" variety (such as agency brokerage) which add less relative value. The most sophisticated product specialists are mostly still here and some new ones have arrived with the skills to take advantage of new kinds of opportunity - for example, corporate restructurings, mergers and acquisitions, and private equity investment.

A more serious concern is the fact that Hong Kong's cost base is still high by the standards of major international centres, even after the reductions in staff costs, property prices and rental rates which have occurred in the last 12 months. This matters *vis-à-vis* other Asian centres such as Singapore, particularly in the key area of fund management. It matters equally in relation to global centres such as London and New York, which now threaten (more than other Asian centres do) to grow at Hong Kong's expense in global activities such as putting together complex corporate finance transactions, packaging and floating debt and equity issues in the international markets, constructing and selling derivative products and trading international bonds and other OTC securities. Relative costs are an important factor influencing the decisions of global financial institutions about where to locate different activities. Hong Kong may (at this stage) have few rivals as a centre for China-related business. But Hong Kong's value in this context, as well as its future weight as a financial centre generally, will be profoundly affected by the extent to which we achieve a position as one of the major "poles" of global market activities. Hong Kong's position in this context is far from assured. Cost competitiveness will influence the extent to which Hong Kong is used as a base for the "high-tech" activities of international banks, fund managers, information vendors, trading systems, securities houses, investment banks and others. This lies at the heart of the "critical mass" phenomenon.

Also essential to the establishment and maintenance of "critical mass" is the availability of relevantly skilled people in the local labour market. This is an area where Hong Kong is also skating on thin ice. Although a considerable number of Hong Kong people have in recent years acquired the skills and product knowledge to participate in sophisticated, global market activities, the main source of such practitioners is still the "Anglo Saxon" financial centres. To create a larger indigenous supply of individuals with the right educational background and training calls for a directed and sustained effort by Government, supported actively by the industry.

The constitutional and organisational structures of Hong Kong's financial market institutions, notably the Stock and Futures Exchanges, also look increasingly outdated and inappropriate in the global context (as I have argued publicly a number of times). The most urgent need is for a separation of ownership from trading rights, to prevent the vested interests of exchange members from obscuring or distorting the organisation's strategic vision and blocking or retarding the implementation of measures which would make the Hong Kong market more competitive and efficient. Constitutional change of this nature may be a necessary prelude to closer integration of the cash and derivative markets, the need for which is also likely to be ultimately inescapable. I am well aware of the controversy which reforms of this nature may arouse. But our local brokerage community has also become more sophisticated in recent years and I believe there is now a wider recognition that change is necessary. Nevertheless a clear strategic vision and determined lead from Government is essential to bring about such reform. If we fail in this area, Hong Kong's exchanges will be seriously hampered in implementing strategies to help them emerge in a strong position from the inevitable consolidation of markets which will take place in Asia, as it is already doing in Europe.

In the regulatory area, Hong Kong retains the advantage of a relatively unburdensome regime which is still perceived as being reasonably effective. Nevertheless, there are weaknesses in our investor protection framework which have been evident for many years and which will matter increasingly as investors compare Hong Kong with more tightly regulated developed markets. One of the top priorities in this context (as I have also argued publicly on a number of occasions) is the introduction of more effective means of enforcing rules designed to protect minority shareholders against abuse by controllers or managements of listed companies; these would include basic statutory obligations for directors of listed companies and statutory penalties for serious breaches of Listing Rules or the Takeover Code. Our present systems for dealing with insider trading and company investigations are also out-moded and cumbersome. And our systems for dealing with cross-border and inter-market abuses, including new and more sophisticated forms of market manipulation, need to be strengthened (though this is part of a wider and necessary international effort).

These are only some of the areas in which I believe Hong Kong needs to become fitter if it is going to keep up in the global race. Most of the actions required lie within our own capabilities, though they call for considerable effort and commitment from the top to implement.

Hong Kong's success as a global centre in the long term will, however, be closely bound up with our success in becoming not just a "window on China and China's window on the world", but the main international financial centre of a China which will be part of the world market. For reasons of history, Hong Kong is still an "offshore" financial market as far as the Mainland is concerned. The absence at this stage of full RMB convertibility limits the extent to which the Hong Kong market can intermediate between Mainland enterprises and international investors, or help to channel Mainland savings to productive use. The potential synergies between Hong Kong and the Mainland in the financial market area are vast, but at this stage they can only be exploited to a very limited extent. This is not to belittle the considerable achievements of Hong Kong and the Mainland, working together in this area over the past five years, including development of the "H" share market, and expansion of Hong Kong's Red Chip sector. Despite the fact that such counters have been caught severely in the Asian downturn, these foundations are still in place. But where do we go from here? What are the next steps which will allow the financial market skills accumulated in Hong Kong to play a larger role in restructuring the Mainland economy and simultaneously give Hong Kong what it still lacks - a real financial market hinterland?

I do not have ready-made answers to this question. These lie to a large extent in the hands of Mainland leaders. However, I would like to suggest certain directions in which some of the answers might be sought.

The first of these is the area of derivatives. As the management of Mainland enterprises becomes more sophisticated, they will seek more sophisticated ways to manage their financial risks. Some enterprises have already for years been making extensive use of derivative markets in the USA and elsewhere to protect against international risks. However, many of the risks faced by these enterprises, as well as by foreign investors in China, are of a domestic nature - RMB interest rate movements, for example. The present limited convertibility of the RMB should not be an insuperable obstacle to the creation in Hong Kong of instruments to hedge such risks. Expertise in this area is plentiful in Hong Kong, in addition to a regulatory framework with considerable experience in managing market risk. Over time, demand for such instruments will grow. If a market does not develop within China, it will eventually do so elsewhere.

A more significant contribution to the development and efficiency of Mainland markets would be made if Hong Kong-based financial institutions could participate more extensively in Mainland securities markets - for example in the area of managing mutual funds, provident and pension schemes, life assurance and other forms of contractual savings. This would assist Mainland markets to establish an institutional investor base, thereby hastening their maturation and simultaneously providing a mechanism for directing savings to economically productive use. Similarly in the investment banking field - structuring and underwriting domestic issues of securities and providing advisory services on corporate financial transactions. The principle of foreign participation through joint ventures in this area has been established. Much of the expertise assembled in Hong Kong in these fields of activity resides in internationally-controlled firms. But the personnel are increasingly local. Surely it is better to import such expertise from Hong Kong than from elsewhere.

As partnership between Hong Kong and the Mainland develops in the financial market area, linkages between stock exchanges should also be extended. Although there is some rivalry between Hong Kong and Shanghai (which I will revert to later), each will have an eventual interest in selling the other's products. Both geography and complementarity of products should bring Shenzhen and Hong Kong closer. Hong Kong has the expertise in "high-tech" financial services, as well as the developed market infrastructure. Shenzhen has established access to the Mainland investor base. It may not at this stage be possible to link up these highly complementary elements, but the ground needs to be laid now for what is a natural future partnership.

I do not under-estimate the difficulties of attaching an established international financial centre to a still immature emerging market. We have seen some of these already in the Red Chip sector. But the learning process has been started and has already recorded some successes. The only way to narrow the cultural gap is to increase steadily the intermixing of markets, while co-operating closely in the regulatory field to pre-empt or deal with market abuses. There is a risk that Hong Kong standards will get diluted in some sectors of the market. But it is a risk that must be taken in the interests of both Hong Kong and China as a whole. The Mainland market will also benefit from increased exposure to the standards demanded by international markets. Hong Kong itself had to work its way gradually up this learning curve. International investors may initially shy away from less established Mainland counters. But the potential rewards will eventually tempt them, as their level of comfort with the market gradually grows and the volume on offer increases. This may sound optimistic in the present depressed state of the market, but I believe it will look like a glimpse of the obvious in a few years' time.

While all this is happening, the global markets will not be standing still. Asia may not quickly acquire a common currency, in the way that Europe is doing, but the linkages between markets will nevertheless increase fast. Alliances will be formed between exchanges in Asia, and (perhaps more importantly) between Asian exchanges and their counterparts in Europe and North America, to sell each other's products or jointly develop new products. Hong Kong exchanges will need to be on their toes to identify and link with the most desirable strategic partners. These might include the operators of supra-national electronic trading systems. Volume and liquidity will be the name of the game. The extent to which Hong Kong is seen as having access (actual or potential) to the investor base on the Mainland will influence our leverage in this mating game. If our exchanges are run as businesses, without the historical incubus of membership-based governance structures, we will have a much greater capability to be proactive in anticipating market trends and taking the initiative, as opposed to adopting a reactive posture while exchanges in other financial centres make the strategic running.

The relationship of Hong Kong to Shanghai will be somewhat schizophrenic. On the one hand, there is a high level of complementarity. Both centres will benefit from growth of China's securities industry. Shanghai is at present China's main domestic centre; Hong Kong its main international centre. But the barriers between domestic and international markets must eventually disappear. Shanghai has made no secret of its international ambitions. Hong Kong should not be squeamish about eventually seeking to play an important domestic role. That is a natural and necessary evolution, and will strengthen Hong Kong's position in the international race. There is nothing wrong with having two competing financial centres in a big market - witness New York and Chicago. The important thing is that they compete on the basis of their efficiency and the benefits they bring to market users, rather than in trying to exercise political influence to get the evolution of markets directed in their favour by the hand of government. Successful financial centres are those which are created by markets. The role of government should be confined to providing a sound and objective legal and regulatory framework.

But competition between Hong Kong and Shanghai is not the major issue in the context of the race between financial centres for position in the global market of the future. For Shanghai to create the critical mass which already exists in Hong Kong of international firms, practitioners, product knowledge and financial market activity would require many years, as well as significant cultural changes. The global race between financial centres did not start yesterday. It has already run several laps. Hong Kong has an established position - well behind New York and London, but ahead of most continental European markets in terms of the volume of international business transacted. Within Asia, we face determined competition from Singapore, which is now trying hard to make its regulatory regime more user-friendly and to take advantage subtly of concerns among investors and depositors about Hong Kong's political future. In the commercial banking field, Singapore is running Hong Kong close. In the faster-growing securities markets, Hong Kong still has considerably greater critical mass.

Tokyo's position is different and complex. Having missed the opportunity presented to it on a plate in the 1980s to become one of three dominant world financial centres, Tokyo has now belatedly embarked in earnest on a programme of de-bureaucratisation and market opening. Foreign banks, securities houses and fund managers are flooding in, bringing with them new ideas and financial products. But their main target is the domestic Japanese market, in particular the huge volume of household savings. The extent to which Tokyo is likely to become a base for managing business in China and Southeast Asia appears limited - partly due to the cultural gap between Japan and the rest of Asia and partly to the high cost of operating from Tokyo. Thus, the Japanese horse has somehow veered off the track into a different direction.

That leaves Hong Kong as still the leading Asian horse in the global race. Being now part of China, and having shown that the transition has not undermined our market institutions or legal framework or the free flow of information, Hong Kong's position should be stronger than ever. We have a new and growing dimension to our market, which will eventually evolve into a true hinterland for the financial skills assembled in Hong Kong. The extent to which we are able to realise the benefits of this new position will depend on four things in particular: First, whether we can modernise our market institutions to make them competitively fit. Second, whether we can enhance our critical mass of financial market professionals by increasing their local supply and maintaining Hong Kong's attractiveness to highly qualified expatriates. Third, whether we can maintain our costs at a level comparable to those of competing global centres. And fourth, perhaps most important of all, whether we can mobilise the full support of China's leadership for the Hong Kong horse by allowing Hong Kong to take fuller advantage of its natural, expanded "home" market.

Postscript (August 2001)

Looking back over the three years since this was written, it is remarkable how much history can be compressed into such a short period. The evolution of China's domestic securities markets has been so rapid that it is already possible to envisage their acquiring a scale and self-sufficiency analogous in a manner to the USA. Such scale is derived mainly from the size of the pool of domestic savings, and China's improving ability to mobilise it, which make the importation of capital through the equity market decreasingly essential to China's growth. We can now clearly foresee a world in which China is the dominant securities market in Asia. Thus China as a whole will have won the "horse race".

But what will Hong Kong's role be within China? That is the issue facing policy-makers in Hong Kong today. They can determine the outcome to a limited extent by succeeding (or failing) to keep Hong Kong in the vanguard of international securities market development. But the crucial factor, which is outside their control, is the timing of the arrival of full RMB convertibility. When this happens, Hong Kong will become an integral part of China's market, able to play a full role in re-cycling the enormous pool of domestic savings - both within China and from China to the outside world.

Geoffrey Yeh

Hong Kong Futures Exchange - Playing a Leading Role in Hong Kong's Financial Infrastructure

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Rotary Club of Kowloon Luncheon
4 February 1999

There is so much to talk about when it comes to futures that I have often been accused of being long-winded. Although I did not grow up as a futures practitioner, I have been on the Board of the Hong Kong Futures Exchange for over eight years - most of the time as Vice-Chairman and recently as Chairman. So futures is really a topic close to my heart.

The attack on the Hong Kong dollar last August and the subsequent events which followed it brought the Hong Kong Futures Exchange more than its usual share of the spotlight. With it too came more than its usual share of misunderstanding. So I am pleased to be able to speak to you directly, and hope that I can shed some light onto the situation as it really exists today.

To do this I will inform you how the Exchange has grown to become a principal player on Hong Kong's financial stage. Then I will talk about the major market participants, and the main types of risk. Finally I will brief you on what we are doing to bring the Exchange into the next Millennium.

So, if you will excuse the ambiguity, back to the Futures.

Setting the Stage

The Hong Kong Futures Exchange (HKFE) was born in December 1976 out of the Hong Kong Commodity Exchange which changed its name in 1985 to what we are known today.

The Exchange started successfully trading financial futures, Hang Seng Index Futures, in 1986 but it met its first crisis a year later when, no doubt, many of you may still remember, trading was suspended for four days following the Black Monday Market Crash of October 1987.

Regrettably, this resulted in some of our Members then being unable to meet their margin calls. Those were dark days for the Exchange.

But time moved on, and we learned, and Hong Kong learned. In 1993, the Exchange diversified into options - the Hang Seng Index Options - complementing our Hang Seng Index Futures. Two years later, we launched our Automated Trading System (we call it the ATS), to complement our open outcry method of trading, with an aim to eventually replacing it. I shall say more about this later.

Our open outcry system operates from a modest size trading floor with over 300 traders in their different coloured jackets crying out their bargains in the pit using the most traditional channels of voice and hand signals. A lot of major futures exchanges are still hanging on to this system, but the global trend is to go electronic.

We currently trade eight product groups with a 1998 annual turnover of 8.5 million contracts. Among these, our flagship product - Hang Seng Index Futures - remains one of the top few stock index futures globally.

On the international stage we play our part too. The HKFE was one of the ten exchanges, and the only one based in Asia, to set up the global task force that produced the 60 recommendations following the Barings Incident in 1995. In addition, our former Chief Executive, Ivers Riley, who remains a special consultant to the HKFE, is currently President of the International Options Markets Association.

The Exchange itself is governed by a Board of 13 directors. Some of them represent Member firms, while others come from a variety of business, academic and non-market practitioner backgrounds. It is structured under a non-executive Chairman, currently myself, and a Chief Executive, Mr Randy Gilmore. Until 1995, Randy was Deputy Chairman of the Securities and Futures Commission (or the SFC).

There are over 130 Members, the majority of which are registered as "Futures Commission Merchants", a name which has had thrust upon it in recent months the pejorative overtones associated with "speculators" and about which I shall also say more later.

Clearing and settlement of contracts are executed by HKFE Clearing Corporation, which is a wholly-owned subsidiary of the Exchange. Its function is to act as counterparty to each side of every trade, thus removing the risk of default and guaranteeing that all contracts are honoured.

And we are regulated by the SFC in the same way as the Stock Exchange, and governed by five different Ordinances.

Hedgers, Speculators, Arbitrageurs

On the global financial stage, there are different people playing different roles in the futures market. Most of them fall into three categories - hedgers, speculators and arbitrageurs.

First, hedgers. The more conservative use of hedging is where a market user wishes to enter into a position as an investor or to protect an open position (one in which he has commodities, currency or securities bought but not sold) that is likely to fluctuate in price over the period that the position remains open. For instance, an investor with a long equity position might hedge against a future fall in equity prices.

In other words, futures provide a formalised method of transferring risk from those wanting to reduce their market exposure, to those willing to accept the risk - of course, for a reward.

So much for hedgers. What of "speculators"?

Sometimes referred to as "directional traders", speculators may be the highest flying gamblers on the financial stage, but they should not be universally denigrated. After all, they are prepared to accept the risk which more conservative investors wish to offset. As such, they are vital to the success of Hong Kong's futures market, and indeed the financial market as a whole, as it is their interaction with other market users that provides liquidity in the market, facilitating investors, fund managers, banks and companies to trade in the market effectively.

So, there is indeed a positive side to speculative activities. What then of arbitrageurs?

They are one group of market users, sometimes wrongly branded "short sellers". These are, technically, completely non-speculative. Here, positions from one market are transferred to another to take advantage of price differences between the two markets. It is not speculative as the trader will only switch from one market to another knowing exactly what the rates or prices are in both markets and will only switch if the profit outweighs the cost of the trade. These "arbitrageurs" too play a vital role in the global marketplace as their activities help smooth out market and price inefficiencies in related markets and products.

Hedgers, speculators, arbitrageurs. They form the tripod of any successful futures market because between them they create liquidity.

Risk

Having talked about the three major roles on the "futures" stage, it is time to discuss the theme of the drama itself. If I were to sum it up in just one word, I would choose the word "risk". Indeed, risk (or the transfer of risk) is what the futures business is all about, and the principal role of the HKFE is to provide the forum, a marketplace where hedging and risk sharing can take place for the investment community.

What then is risk? Risk falls into four main areas - Counterparty risk; Market risk; Legal risk and Systemic risk.

Counterparty Risk is associated with the guarantor role played by our Clearing House, which we own. In effect it is a form of credit risk because should a Member default on a transaction, the Clearing House is responsible for ensuring payment to non-defaulting Members. This concept also extends to any external organisation for which the Exchange deals on a regular basis, for example settlement banks and custodians.

The next is **Market Risk** - when volatility in the market increases, risk increases, and thus, in times of acute volatility, the Clearing House will impose intra-day margin calls to ensure that every position is adequately covered. These intra-day margin calls have to be settled within 60 minutes and only in some extremely rare cases have the calls not been met, in which case the Member may be barred from entering into new positions and may be forced to liquidate others. This excellent record over many years testifies to the prudence of our risk management system.

The third kind of risk, **Legal Risk**, occurs if a dispute were to arise between the Clearing House and its settlement bank over the finality of transfers between deposit accounts of the clearing Member and the Clearing House.

Finally, **Systemic Risk** - as it is the Exchange's duty to collect margins from Members holding open positions on the Exchange, it is imperative that the banks into which these monies are placed by the Clearing House are thoroughly scrutinised for integrity and creditworthiness. And there is the Money Settlement system itself. Any failure in the system will affect the risk exposure of the Clearing House.

Some of these risks I have mentioned may seem extremely remote, but considering the colossal size of transactions undertaken by the global fund managers, they are absolutely necessary. It is the HKFE's view that if Hong Kong is to hold its head high and grow in stature as an international financial centre, we must maintain the lead where risk management is concerned.

What are some of the other measures we take to manage risk?

Time does not allow me to run through them in detail, but they are both comprehensive and effective. Indeed, they are tougher than most, if not all, other exchanges in the world. Trigger points on margin calls are constantly reassessed in light of the degree of volatility, position limits are controlled tightly and are strictly adhered to, and the Reserve Fund is maintained at a level covering considerable market risk. Indeed we at the HKFE believe that one of the Exchange's major achievements has been its "success in managing risk in extreme volatility". One such period was the third quarter of 1998 - a period to which we look back with pride.

1999 - The Year of the Future

But what of the future?

I believe 1999 will be truly "The Year of the Future" for the HKFE, for one major reason, above all others. Electronic trading.

While we first launched ATS in November 1995 and at present most of our products are already being traded electronically, our two flagship products - Hang Seng Index Futures and Hang Seng Index Options - which account for about 90% of our trading volume, are still traded on the open outcry system, although such days are numbered. This year, we are pressing ahead full speed with the phasing in of the HK$100 million computerised system, which will allow these two products to be migrated to the ATS, thus making the HKFE a fully electronic marketplace.

We will, however, not announce the date of full migration until the new electronic trading system has been thoroughly tested by both ourselves and our Members, and that we are all confident in a totally successful 'premiere'. But I do hope we can make such an announcement before very long.

Why did we decide to go electronic? We believe to compete with the world's best in what is increasingly a 24-hour global market, we simply have to be as good as the best, and better if we can possibly achieve it.

I will close by quoting from the recently appointed new Chairman of the SFC, Mr Andrew Sheng, who summed it up very clearly when he said, "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." Well, that just about says it all!

Using the theatrical simile, I believe that the role of the HKFE is to provide the stage, to attract the international players, to set the rules, and to fill the house with a growing body of enthusiastic supporters. I believe we are achieving all of these, and more international players want to appear on our stage, thus enticing even more supporters.

The 'premiere' of the full migration to electronic trading this year will again place us squarely in the spotlight. The world will be watching, and we have every confidence that Hong Kong will have one more success story to tell.

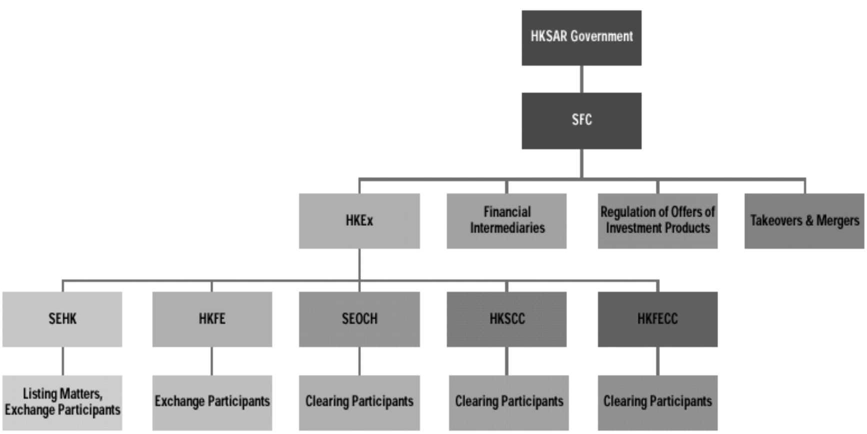
Appendix

Hong Kong's Securities Markets – Key Indicators

REGULATORY STRUCTURE OF THE SECURITIES MARKETS

The regulatory structure of the securities markets in Hong Kong is depicted in Chart 1. The Securities and Futures Commission (SFC) was established in May 1989, based on the recommendations of the Ian Hay Davison Report on The Operation and Regulation of the Hong Kong Securities Industry in May 1988. Hong Kong Exchanges and Clearing Ltd (HKEx) was established following the comprehensive market reform of the securities and futures markets announced by the Financial Secretary in March 1999. The reform of the exchanges involved the demutualisation of The Stock Exchange of Hong Kong Limited (SEHK) and Hong Kong Futures Exchange Limited (HKFE), and the merger of these two exchanges and their associated clearing houses into a single holding company, HKEx, on 6 March 2000. HKEx was listed on 27 June 2000.

Chart 1 - Regulating the Securities Market



- HKSAR Government - The Government of the Hong Kong Special Administrative Region
- SFC - Securities and Futures Commission
- HKEx - Hong Kong Exchanges and Clearing Limited
- SEHK - Stock Exchange of Hong Kong Limited
- HKFE - Hong Kong Futures Exchange Limited
- SEOCH - SEHK Options Clearing House Limited
- HKSCC - Hong Kong Securities Clearing Company Limited
- HKFECC - HKFE Clearing Corporation Limited

Source: SFC

DEVELOPMENTS IN THE SECURITIES MARKETS

Overview

Hong Kong's securities markets are well developed, with its equity market ranking tenth place in the world by market capitalisation, and second position in Asia-ex-Japan as at end 2001. The derivatives market ranked number four in Asia-ex-Japan as at December 2001, and there is potential for much further growth and development. Table 1 provides some major indicators of the securities markets.

Table 1 - Major Indicators of the Securities Markets in Hong Kong (Period-end figures unless otherwise specified)

Cash Market		1988	1992	1996	2000	2001
Main Board						
Number of Listed Companies		304	413	583	736	756
Market Capitalisation	Total	580	1,332	3,476	4,795	3,885
(HK$ billion)	HSI Constituents	404	941	2,436	3,866	3,136
Worldwide Ranking by Market Capitalisation		17 (a)	8	7	10	10
Market Capitalisation to GDP (%)		127	171	292	382	306
Market Value of Top 10 Stocks over Total Market Capitalisation (%)		46	47	52	68	64
Average Daily Turnover	Total	804	2,802	5,672	12,338	8,025
(HK$ million)	HSI Constituents	442	1,490	3,075	5,677	4,558
Number of Trading Days		248	250	249	247	243
Liquidity (%) (Turnover / Year-end Market Capitalisation)		34	53	41	64	50
Hang Seng Index (HSI)		2,687	5,512	13,451	15,096	11,397
P/E ratio (HSI)		12.51	14.23	17.30	12.74	15.06
Funds Raised (HK$ billion, annual)		19	105	100	451	59

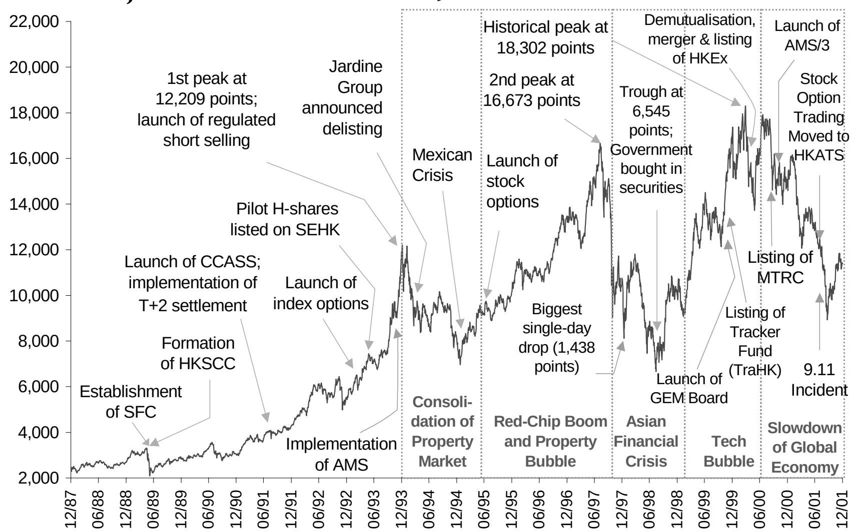
Cash Market		**1988**	**1992**	**1996**	**2000**	**2001**
Growth Enterprise Market						
Number of Listed Companies		n.a.	n.a.	n.a.	54	111
Market Capitalisation (HK$ million)		n.a.	n.a.	n.a.	67,290	60,964
Average Daily Turnover (HK$ million)		n.a.	n.a.	n.a.	341	162
Growth Enterprise Index (GEI)		n.a.	n.a.	n.a.	309.42	199.42
Funds Raised (HK$ billion, annual)		n.a.	n.a.	n.a.	16	5.8
Derivatives Market						
Types of Products		1	1	5	6	8
Turnover	All Products	140	1,089	7,215	9,261	10,550
('000 contracts, annual)	HSI Futures	140	1,089	4,656	4,023	4,400
	HSI Options	n.a.	n.a.	1,094	544	716
	Stock Options	n.a.	n.a.	1,270	4,189	5,202
Open Interest	All Products	1,163	14,212	147,493	534,975	356,870
(contracts)	HSI Futures	1,163	14,212	38,524	31,246	33,138
	HSI Options	n.a.	n.a.	56,841	10,519	29,741
	Stock Options	n.a.	n.a.	50,981	462,494	231,657

Remarks: (a) 1990 figure
n.a. - not applicable
Sources: HKEx, FIBV, HSI Services Limited

Price Indices

The stock market of Hong Kong climbed to the first peak in January 1994 when the property market took off and Mainland companies began to list in Hong Kong in the form of H-shares and Red Chips. The red-chip boom that followed pushed the Hang Seng Index (HSI) to the second peak of 16,673 points in August 1997. With the onset of the Asian Financial Crisis, the HSI plunged to an intraday low of 6,545 points in August 1998 before the HKSAR Government bought in securities. Following the turnaround in the economy and the tech fever, the index climbed to a historical high of 18,302 points in March 2000. The tech bubble burst thereafter and continued into 2001, concurrent with the slowdown of the global economy. The HSI fell to a 30-month low of 9,210 after the 9.11 incident and rebounded to pre-9.11 level within a month. It continued to strengthen to end the year at 11,397 points (Chart 2).

Chart 2 - Major Stock Market Events : 1988- 2001

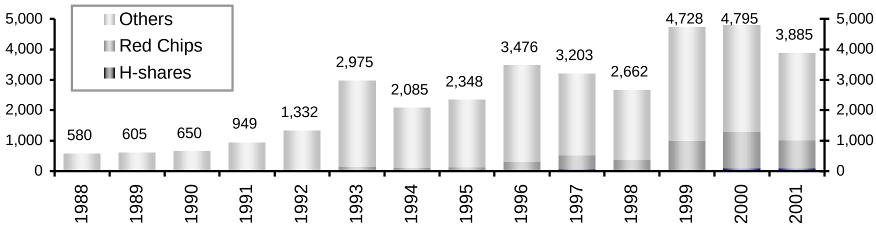


Sources: Bloomberg and HKEx

Market Capitalisation

Since 1988, capitalisation of the Hong Kong stock market has expanded 5.7 times and was the second largest market in Asia-ex-Japan and tenth largest in the world at the end of 2001. One of the contributing factors is the listing of Mainland enterprises (H-shares and Red Chips) from 1993 onwards (Chart 3). At the end of 2001, the value of Mainland enterprises listed on HKEx amounted to HK$1,012 billion, accounting for 26% of total market capitalisation.

Chart 3 - Market Capitalisation of the Main Board from 1988 to 2001 (HK$ billion)

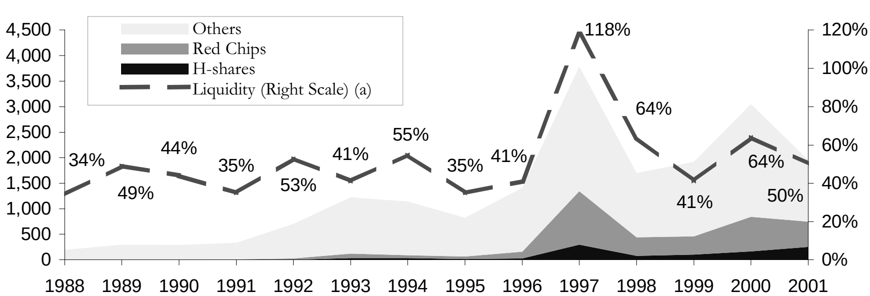


Source: HKEx

Market Turnover

Market turnover rose from an average of HK$364 billion per year from 1988-1992 to HK$1,678 billion per year during 1993-1997 (Chart 4). 1997 marked the record annual turnover of HK$3,789 billion (or an average daily turnover of HK$15.5 billion). Turnover shrank by more than half during the Asian crisis and recovered strongly in 2000 (with annual turnover of HK$3,048 billion or average daily turnover of HK$12.3 billion). Trading value dropped again in 2001, attributable to both broad declines in stock prices and higher perceived risks after the 9.11 incident.

Chart 4 - Turnover of the Main Board from 1988 to 2001 (HK$ billion)



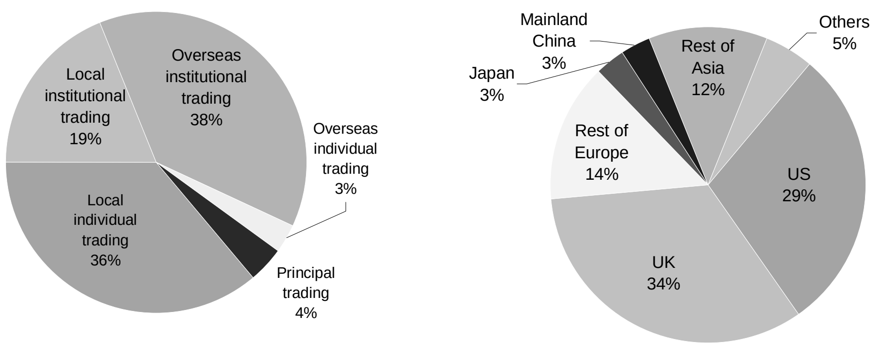
Remark: (a) Liquidity (%) is derived from annual turnover divided by year-end market capitalisation

Source: HKEx

Investor Base

In terms of investor base, Hong Kong provides a level playing field with a balanced proportion of institutional and individual investors (Chart 5).

Chart 5 - Turnover of the Hong Kong Stock Market by Type of Investors and Geographical Distribution of Overseas Investors in 2001 (%)

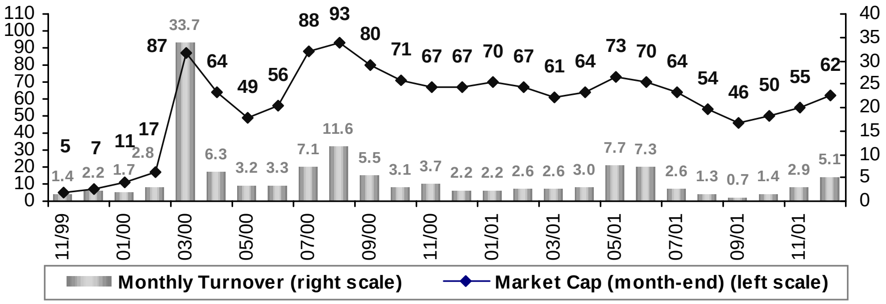


Source: Cash Market Transaction Survey, HKEx

Second Board - Growth Enterprises Market (GEM)

At the end of 2001, GEM was the third largest second board in Asia after Korea and Taiwan. Similar to most second boards around the globe, the second board is mainly composed of technology and telecommunication companies. Market capitalisation peaked in August 2000, and then shrank following the burst of the tech bubble (Chart 6). Since its inception in November 1999, US$3 billion has been raised from the GEM board.

Chart 6 - Capitalisation of the Growth Enterprise Market (GEM) since Inception in November 1999 (HK$ million)

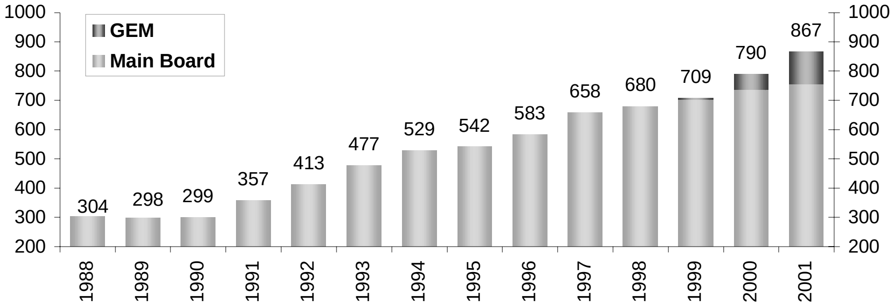


Source: HKEx

Number of Listed Companies

The number of listed companies rose at a steady rate from 1990 onwards (Chart 7). Most of the listed companies on the Main Board are engaged in a wide range of services industries, while most GEM companies are much smaller and younger companies with growth potential, and are more concentrated in emerging industries.

Chart 7 - Number of Listed Companies (1988 - 2001)

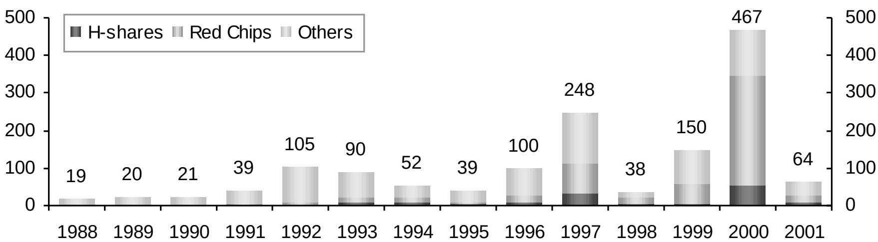


Source: HKEx

Funds Raised in the Primary Market

The Hong Kong stock market raised a tremendous amount of funds during 1996 - 2000, reflecting the strong demand by Mainland enterprises to raise funds through Hong Kong (Chart 8). Two big deals initiated by Mainland enterprises in 2000, amounting to HK$279 billion, contributed to a record total of HK$467 billion raised during the year. However, fund-raising activities slowed in 2001, amidst sluggish market sentiment around the globe and fewer asset acquisitions initiated by the listed companies.

Chart 8 - Funds Raised Directly and Indirectly through Hong Kong (HK$ billion)



Source: HKEx

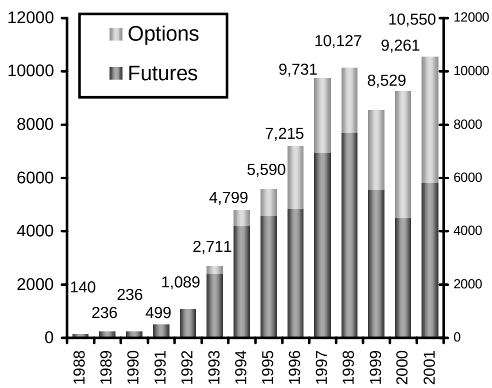
Derivatives Market[1]

The derivatives market in Hong Kong is growing in both size and diversity. At the end of 2001, trading volume of all derivatives amounted to 10.6 billion contracts, compared with 0.14 million contracts in 1988 (Chart 9). Currently Hong Kong is the fourth largest derivatives market in Asia-ex-Japan, offering eight types of derivative products mainly on stocks and indices[2] (Chart 10). The most actively traded derivative

[1] Derivatives primarily refer to futures and options listed on the exchanges.
[2] Including index options and futures, stock options and futures, rolling forex, HIBOR futures, EFN futures and international stock options (options on futures).

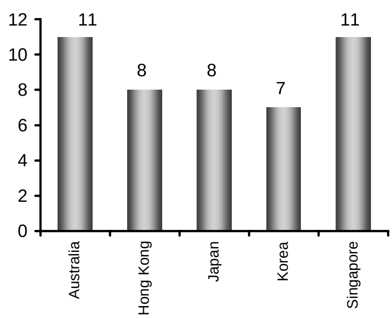
product is the HSI Futures. Some of the more successful products are stock options, HIBOR futures and Mini-Hang Seng Index (Mini-HSI) Futures. HKEx trades MSCI China Free Index Futures and international stock futures and options based on 20 stocks trading in US, Japan, Korea and Taiwan, as well as Three-Year Exchange Fund Note (EFN) Futures.

Chart 9 - Total Turnover of Derivative Products in Hong Kong ('000 Contracts)



Sources: websites of various exchanges

Chart 10 - Types of Products Offered in Various Exchanges (as at end 2001)



Sources: websites of various exchanges & FIBV

Authorised Investment Products

The number of unit trusts and mutual funds more than doubled during the past decade and accounted for over 82% of all authorised investment products as at 31 March 2001 (Table 2). Equity funds have been the most popular product, growing 14 times in terms of net asset value between 1990 and 2001 (Table 3). As at end-March 2001, there are 263 Mandatory Provident Fund (MPF) master trust schemes and pooled investment funds for the purpose of MPF.

Table 2 - Authorised Collective Investment Schemes (as at end of March)

Type of Authorised Products	1991	1994	1998	2001
Unit trusts & mutual funds	920	903	1,526	1,870
Investment-linked assurance schemes	35	57	61	76
Pooled retirement funds	34	36	58	40
Immigration-linked investment schemes	9	8	11	0
MPF master trust schemes	n.a.	n.a.	n.a.	49
MPF pooled investment funds	n.a.	n.a.	n.a.	214
Others	n.a.	3	20	18
Total	**998**	**1,007**	**1,676**	**2,267**

n.a. - not applicable

Source: SFC

Table 3 - Origin / Net Asset Value of Authorised Unit Trusts and Mutual Funds (US$ Million)

	1991		1994		1998		2001	
	No of Funds (a)	NAV (b)	No of Funds (a)	NAV (b)	No of Funds (a)	NAV (b)	No of Funds (a)	NAV (b)
By Type								
Bond	116	6,525	118	8,628	210	12,718	307	44,544
Equity	481	14,317	457	29,550	829	100,503	1,118	219,934
Diversified	51	1,141	15	2,200	93	9,586	128	26,869
Money Market	189	3,343	175	3,862	189	7,078	74	15,788
Fund of Funds	15	259	9	149	29	591	77	2,529
Warrant	21	173	21	443	15	277	4	22
Other Specialized (c)	2	19	41	661	31	1,629	22	1,765
Umbrella Structures	45	n.a.	67	n.a.	130	n.a.	140	n.a.
Total	**920**	**25,777**	**903**	**45,493**	**1,526**	**132,383**	**1,870**	**311,449**
By Region								
Hong Kong	139	2,630	73	1,729	71	1,991	75	5,982
Jersey	130	1,606	75	3,118	79	2,839	59	6,010
Luxembourg	268	3,436	285	8,871	674	48,905	1,036	183,502
Ireland	-	-	62	4,501	191	11,682	299	37,211
Guernsey	120	2,727	127	3,461	175	5,541	95	3,644
United Kingdom	91	7,334	40	11,376	23	8,401	68	31,011
Other Europe	8	5,316	11	4,512	10	5,283	15	15,172
Bermuda	43	875	67	1,254	66	1,601	30	1,073
Bahamas	19	495	22	623	8	419	4	20
British Virgin Islands	-	-	25	1,965	34	2,846	26	2,215
Cayman	75	587	103	3,028	184	4,409	149	5,474
Others	27	773	13	1,057	11	38,466	14	20,136
Total	**920**	**25,777**	**903**	**45,493**	**1,526**	**132,383**	**1,870**	**311,449**

Remarks: (a) As at 31 March of the year
(b) As at 31 December of the preceding year
(c) Include Futures & Options funds, Guaranteed funds & Leveraged funds
n.a. - not applicable

Source: SFC

Registered Intermediaries

The number of licences issued has increased threefold in the 1990s concurrent with the expansion of the securities market (Table 4a and 4b). There was a significant increase in applications for registration under the Securities Ordinance towards the end of March 2001 in anticipation of the new competence requirement effective 1 April 2001.

A new class of registrants called "securities margin financier" was introduced by the Securities (Margin Financing) (Amendment) Ordinance 2000. Just prior to the enactment of the Ordinance, most of the finance companies that previously provided securities margin financing either terminated their business or transferred it to their associated dealer firms. As at 31 March 2001, there were 10 registered securities margin financiers and 268 securities margin financier's representatives.

Table 4a - Number of Registered Intermediaries (Licensed Firms) (as at end March)

Business	1990	1993	1997	2000	2001
Under Securities Ordinance					
Dealers	801	685	680	701	725
Advisers	417	509	620	621	659
Margin Financiers	n.a.	n.a.	n.a.	n.a.	20
Sub-Total	**1,218**	**1,194**	**1,300**	**1,322**	**1,404**
Under Commodities Trading Ordinance					
Dealers	104	106	155	164	158
Advisers	53	50	124	119	128
Sub-Total	**157**	**156**	**279**	**283**	**286**
Under Leveraged Foreign Exchange Trading Ordinance					
Discretionary Traders	n.a.	n.a.	12	8	6
Non Discretionary Traders	n.a.	n.a.	7	5	4
Introducing Agent	n.a.	n.a.	3	3	0
Sub-total	**n.a.**	**n.a.**	**22**	**16**	**10**
Licensed Firms	1,375	1,350	1,601	1,621	1,700

Table 4b - Number of Registered Intermediaries (Licensed Persons) (as at end March)

Individual	1990	1993	1997	2000	2001
Under Securities Ordinance					
Dealers and Representatives	4,109	5,076	8,539	12,175	14,898
Advisers and Representatives	1,155	1,690	3,433	6,118	6,316
Margin Financier's Representatives	n.a.	n.a.	n.a.	n.a.	268
Sub-Total	**5,264**	**6,766**	**11,972**	**18,293**	**21,482**
Under Commodities Trading Ordinance					
Dealers and Representatives	1,246	1,323	3,272	4,257	4,446
Advisers and Representatives	80	80	331	380	409
Sub-Total	**1,326**	**1,403**	**3,603**	**4,637**	**4,855**
Under Leveraged Foreign Exchange Trading Ordinance					
Trader's Representatives	n.a.	n.a.	1,349	998	817
Licensed Persons	**6,590**	**8,169**	**16,924**	**23,928**	**27,154**

n.a. - not applicable

Source: SFC

MAJOR EVENTS DURING 1988 - MARCH 2002

Market Regulations, Codes and Guidelines Issued by the SFC[3]	
1990	Code on Share Repurchases
	Code on Immigration-linked Investment Schemes
	Fit and Proper Criteria
1991	Securities (Disclosure of Interests) Ordinance
	Securities (Insider Dealing) Ordinance
	Code on Investment-linked Assurance and Pooled Retirement Funds
	Code on Unit Trusts and Mutual Funds (1st Edition)
	Rules introducing stock borrowing and lending
1992	Revised Code on Takeovers and Mergers (consolidated with Code on Share Repurchases)
	Securities and Futures (Clearing Houses) Ordinance
1993	Financial Resources Rules for Persons Registered with the Securities and Futures Commission

[3] See website of the Securities and Futures Commission for more details, at http://www.hksfc.org.hk

Market Regulations, Codes and Guidelines Issued by the SFC[3]	
1994	Leveraged Foreign Exchange Trading Ordinance
	Guidelines on Cash Commission Rebates and "Soft Dollar" Benefits received by fund managers from brokers
	Code of Conduct for Persons Registered with the Securities and Futures Commission
	Enactment of s29A of the Securities and Futures Commission Ordinance
1995	Guidance Notes to Registered Persons Regarding Money Laundering
	Guidance on Core Operational and Financial Risk Management Controls for Over-the-Counter Derivatives Activities of Registered Persons
	Code on Unit Trusts and Mutual Funds (2nd Edition)
1996	Consultation Paper on draft Composite Securities and Futures Bill
1997	Management, Supervision and Internal Control Guidelines for Persons Registered With or Licensed by the SFC
	Money Laundering Revised Guidance Notes issued by the Securities and Futures Commission
	Plain language guidelines issued for public announcements by listed issuers
	Code on Unit Trusts and Mutual Funds (3rd Edition)
	Fund Manager Code of Conduct
1998	Revised Code on Takeovers and Mergers
	Client Identity Rule
	Code on Insurance-linked Assurance Schemes
	Code on Pooled Retirement Funds
1999	SFC Code on MPF Products
	Guidance on Internet Regulation
	Registration Guidelines for Intermediaries advising on securities incidental to the marketing of Mandatory Provident Fund Schemes only
	Guidance for Review of Internal Controls and Systems of Trustees/Custodians
2000	Guidelines on eIPO
	Securities (Margin Financing) (Amendment) Ordinance 2000
	Revised Financial Resources Rules for Securities and Futures Intermediaries (2000)
	Guidance Note on the Application of the Electronic Transactions Ordinance to Contract Notes
	Guidance Note for Short Selling Reporting and Stock Lending Record Keeping Requirements
	Draft SFC Composite Bill
	Fit and Proper Criteria (Revised)

Market Regulations, Codes and Guidelines Issued by the SFC[3]	
2001	Guidance on Exempt Fund Manager Status and Exempt Principal Trader Status under the Code on Takeovers and Mergers
	Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet
	Guidance Note on Continuous Professional Training
	Guidance Note on Competence
	Code of Conduct for Persons Registered with the Securities and Futures Commission (Revised)
	Joint Announcement with HKEx on the Market Consultation and Changes to the Rules governing the Listing of Securities on the Growth Enterprise Market
	Consultation on the Offering of Hedge Funds
	Amendments to the mandatory offer provisions of the Hong Kong Code on Takeovers and Mergers
	Revised Hong Kong Codes on Takeovers and Mergers and Share Repurchases (Phase 1)
	Code of Conduct for Share Registrars
	Corporate Finance Advisor Code of Conduct
2002	Provisions for Index Funds in the Code on Unit Trusts and Mutual Funds
	Revised Hong Kong Codes on Takeovers and Mergers and Share Repurchases (Phase 2)
	Guidelines for the Regulation of Automated Trading Services
	Consultation Paper on Proposals for a Scripless Securities Market
	Enactment of the Securities and Futures Ordinance on 13 March

Market Reform	
1989	Establishment of SFC (following the enactment of Securities and Futures Commission Ordinance)
1991	Approval of devolution of listing responsibility to SEHK
	Joint statement with SEHK on compromise agreement on restructuring of the Exchange Council
1993	Listing of Mainland enterprises in the form of H-shares
1994	Launch of regulated short selling
1998	HKSAR Government announced 30-point programme to further strengthen the regulatory and operation systems and enhance the discipline and transparency of the securities and futures markets
1999	Launch of Growth Enterprise Market
2000	Demutualisation and merger of stock and futures exchanges (March), listing of HKEx (June); SFC assumed direct responsibility for the regulation of all securities and futures intermediaries

Financial Infrastructure	
1990	Establishment of Hong Kong Securities Clearing Company
1992	Full implementation of Central Clearing and Settlement System (CCASS) and T+2 settlement
1994	Implementation of Automatic Order Matching and Execution System (AMS)
1996	Launch of AMS Second Terminal System
1999	Setting up of the Steering Committee on the Enhancement of the Financial Infrastructure in Hong Kong
2000	Implementation of AMS/3
	Migration of HSI Futures to Automated Trading System (HKATS)
	Implementation of the system for the electronic submission of Financial Resources Rules returns
2001	Launch of FinNet
	Migration of Stock Options to HKATS

Investor Education	
1992	Announcements of Public Interests (API) - "*Know Your Broker and Do Your Homework*". Subsequent API messages: "*Do your homework and ask the right questions before investing*" (1997), "*Do not follow the crowd*" (1998), "*Learn the rules of the game*" (1999), "*Get the facts before you invest*" (2001) and "*When you invest, bank on facts, not rumours*" (2002)
1993	Establishment of the Investor Hotline
1995	Launch of first Retail Investor Survey
1996	Debut of free investor publication programs
	Publication of investor stories based on closed cases
	5-minute TV series *All About Investing* (投資本色)
1997	Half-hour TV documentaries *Invest Wisely* (投資本色)
1998	Formation of Investor Education Advisory Committee
	Broadcast of the first radio drama
1999	Interactive drama campaign *Don't guess when you invest* (股非估) for secondary school students
2000	Launch of Electronic Investor Resources Centre (eIRC). Revamped in 2002 First series of workshops for secondary school teachers
	Investor Alert on SFC's website on investment risks and market pitfalls

HKEx and SFC

Hong Kong Exchanges and Clearing Ltd (HKEx)	http://www.hkex.com.hk
Securities and Futures Commission (SFC)	http://www.hksfc.org.hk
Investor Resources Centre	http://www.hkeirc.org