

The Operation and Regulation of the Hong Kong Securities Industry

Report of the Securities Review Committee

證券業檢討委員會

香港維多利亞兵房 'O' 座二樓



SECURITIES REVIEW COMMITTEE

Victoria Barracks
1/F, 'O' Block
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本署檔號 OUR REF:

27 May 1988

來函檔號 YOUR REF:

His Excellency Sir David Wilson, KCMG
Governor of Hong Kong
Hong Kong


Sir,

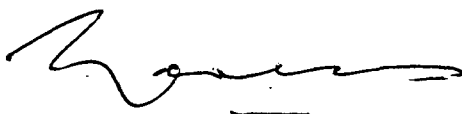
We were appointed to the Securities Review Committee on 16 November 1987 to review the constitution, powers, management and operation of the Hong Kong Stock and Futures Exchanges and their regulatory bodies.

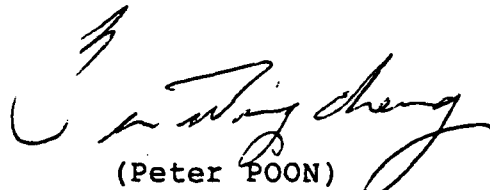
We now have the honour to submit the report of the Committee.


Yours faithfully,


(Ian Hay DAVISON)


(S. L. CHEN)


(LAU Wah-sum)


(Peter POON)


(Charles SOO)



(Philip TOSE)

TABLE OF CONTENTS

paragraphs

Chapter I Overview

Background	1.1 - 1.5
Major criticisms	1.6 - 1.7
Main recommendations	1.8 - 1.11

Chapter II Proceedings of the Committee

Terms of reference	2.1 - 2.3
Modus operandi	2.4
Submissions	2.5 - 2.10
Other overseas reports	2.11
Overseas visits	2.12 - 2.15
Identification of main issues	2.16 - 2.18
Meetings with interested parties	2.19 - 2.23
Visits to the major local organizations	2.24
Format of report	2.25 - 2.26
Acknowledgement	2.27

Chapter III Objectives and Principles

Introduction	3.1 - 3.2
Hong Kong's financial markets	3.3 - 3.9
Strategic objectives	3.10 - 3.15
Market requirements	3.16 - 3.19
The management of risk	3.20 - 3.21
Regulation	3.22 - 3.23
Self-regulation	3.24 - 3.28
Checks and balances	3.29 - 3.35
Costs	3.36
A Hong Kong solution	3.37 - 3.42

Chapter IV The Stock Exchange - Constitution and Management

Background	4.1 - 4.8
Objectives for the Stock Exchange	4.9
CONSTITUTION	
Status of the Exchange	4.10 - 4.20
Constitution of the Exchange	4.21
The governing body	4.22 - 4.29
Corporate representation	4.30 - 4.37
Appointment of independent members	4.38 - 4.40
Inclusion of the Chief Executive	4.41 - 4.42
A balanced composition	4.43 - 4.49
The Nominating Committee	4.50 - 4.53
The Chairman and Vice-chairman of the Exchange	4.54 - 4.57
Voting arrangements	4.58 - 4.66
Transitional measures and permanent safeguards	4.67 - 4.68
Summary	4.69 - 4.70
MANAGEMENT	
Committees and sub-committees	4.71 - 4.72
The Chief Executive and staff	4.73 - 4.74
Major complaints	4.75
Role of the key participants	4.76 - 4.80
The SEHK reform proposals	4.81 - 4.83
MEMBERSHIP	
Present situation	4.84 - 4.86
Major complaints	4.87
Non-trading members	4.88
Admission and training	4.89

Chapter V The Stock Exchange - Operations of the Market

INTRODUCTION	5.1	
SHORT SELLING		
Background	5.2	
Regulations in overseas markets	5.3	
The local scene	5.4	- 5.10
Recommendations	5.11	- 5.13
LISTING OF SECURITIES ON THE EXCHANGE		
Major complaints	5.14	- 5.16
Role of the SEHK Listing Department	5.17	- 5.23
Pricing of new issues	5.24	- 5.25
The new issue queue	5.26	
Shell companies and acquisitions	5.27	
Suspension	5.28	
Sponsoring broker	5.29	- 5.31
Industry bodies	5.32	
DEALING SYSTEM OF THE EXCHANGE		
Present situation	5.33	- 5.35
Market-making system	5.36	- 5.38
Overseas market-making and stamp duty	5.39	- 5.46
SETTLEMENT		
Background	5.47	- 5.54
Weaknesses in the current system	5.55	- 5.60
Settlement procedure	5.61	- 5.62
Settlement period		
Advantages and disadvantages of the existing rule	5.66	- 5.67
Case for amending the rule	5.68	
Optimum settlement period	5.69	- 5.78
Stock borrowing	5.79	- 5.87
Registration	5.88	- 5.93

Central clearing and settlement	
Need for central clearing	5.94 - 5.102
How shares should be held	5.103 - 5.117
The case for a central guarantee	5.118 - 5.128
Risk management system	5.129 - 5.139
Ownership and control	5.140 - 5.147
Board	5.148 - 5.149
Management	5.150
Summary	5.151
SURVEILLANCE OF MEMBERS	5.152 - 5.161

Chapter VI The Futures Exchange - Future and Management

INTRODUCTION	6.1 - 6.2
BACKGROUND	
Futures trading	6.3 - 6.9
The Hong Kong futures market	6.10 - 6.13
The October 1987 failure	6.14
Exchange review and reforms	6.15 - 6.16
FUTURE OF THE FUTURES MARKET	
Viability of the Exchange	6.19 - 6.20
Desirability of a stock index futures market	6.21 - 6.27
The Hong Kong Index futures market	6.28 - 6.34
The role of futures in the crash	6.35 - 6.42
Small speculators and the HSI futures contract	6.43 - 6.45
The Hang Seng Index	6.46 - 6.50
Conclusions	6.51 - 6.58
CONSTITUTION	
Status of the Exchange	6.62
The governing body	6.63 - 6.74
Elections	6.75 - 6.77
MANAGEMENT	6.78 - 6.82
MEMBERSHIP	
Associate members	6.88 - 6.90
Trade affiliated members	6.91 - 6.93

Chapter VII The Futures Exchange - Risk Management Structure

Introduction	7.1	- 7.2
BACKGROUND		
The Exchange	7.4	
The clearing house	7.5	- 7.7
The guarantee corporation	7.8	- 7.11
Legal relationships between the parties	7.12	- 7.19
PROBLEMS		
Guarantee arrangements	7.21	- 7.22
Institutional arrangements	7.23	- 7.31
PROPOSALS		
Institutional structure	7.32	- 7.38
Management of the clearing house	7.39	- 7.40
The guarantee	7.41	- 7.53
Summary	7.54	

Chapter VIII The Futures Exchange - Trading Controls and Surveillance

Introduction	8.1	- 8.2
TIERED MARKET	8.3	- 8.11
FINANCIAL REQUIREMENTS		
Background		
Segregation	8.13	
Margins and daily settlement	8.14	- 8.21
Capital	8.22	- 8.26
Clearing house resources	8.27	
Issues		
Original margins	8.29	
Hedged position margins	8.30	- 8.31
Gross margining	8.32	- 8.34
Direct debit daily settlement system	8.35	- 8.39

Intra-day margining	8.40	
Hong Kong's risk based capital requirements	8.41	- 8.50
Position limits	8.51	- 8.53
Members' fund	8.54	- 8.59
Summary	8.60	- 8.63
FIRM SUPERVISION : FINANCIAL		
Large open position reporting	8.67	
Clearing house surveillance	8.68	- 8.69
Amber lights	8.70	- 8.72
FIRM SUPERVISION : TRADING FLOOR CONDUCT	8.73	- 8.77
MARKET SURVEILLANCE	8.78	- 8.81

Chapter IX The Commissions and the Office of the Commissioner

INTRODUCTION	9.1	
THE CURRENT SYSTEM		
The Commissions	9.4	- 9.8
The Disciplinary Committees	9.9	- 9.10
The Commissioner	9.11	- 9.13
PROBLEMS WITH THE CURRENT ARRANGEMENTS		
The Commissions	9.14	- 9.16
The Disciplinary Committees	9.17	
The Commissioner and his Office	9.18	- 9.28
CREATION OF A NEW SECURITIES COMMISSION	9.29	- 9.35
THE CONSTITUTION AND MANAGEMENT OF THE NEW SC		
Governing body	9.37	- 9.41
Staffing	9.42	- 9.48
Advisory Committee	9.49	- 9.54
RELATIONSHIP BETWEEN THE NEW SC AND THE GOVERNMENT		
Accountability to the Administration	9.55	- 9.58
Day-to-day contact with the Administration	9.59	- 9.65

FUNCTIONS AND OPERATIONS OF THE NEW SC

Policy development	9.67 - 9.68
Regulatory oversight of Exchange/clearing houses	9.69 - 9.73
Direct supervision	9.74
Unit trusts and mutual funds	9.75 - 9.78
Life products	9.79 - 9.80
Takeovers	9.81 - 9.82
Investment arrangements	9.83 - 9.86
New issues and listings	9.87 - 9.88
The role of joint SC-industry committees	9.89 - 9.90
POWERS OF THE NEW SC	
Processes and appeals	9.92 - 9.94
Powers over the Exchanges	9.95 - 9.96
Market closures	9.97 - 9.99
Investigations	9.100 - 9.104
Prosecutions	9.105 - 9.111
SUMMARY	9.112

Chapter X The Regulation of Intermediaries

INTRODUCTION	10.1 - 10.2
AUTHORISATION	
Background	
Dealers	10.6 - 10.9
Advisers	10.10 - 10.13
Problems	
Exchange versus SC authorization	10.16 - 10.17
Authorization criteria	10.18 - 10.19
Annual registration versus licensing	10.20 - 10.28
Exemption	10.29 - 10.35
Directors, controllers and managers	10.36 - 10.38
Representatives	10.39
Dealers versus advisers	10.40 - 10.41

FINANCIAL REQUIREMENTS FOR SECURITIES DEALERS

Objectives	10.42 - 10.43
Purpose of capital adequacy rules	10.44 - 10.47
The existing regulations	10.48 - 10.52
Problems and recommendations	10.53 - 10.64
THE CONDUCT OF BUSINESS	
Background	10.65 - 10.66
Current position	10.67 - 10.69
Problems and issues	
Need for conduct of business rules	10.71 - 10.75
Status of the rules	10.76 - 10.82
Developing and policing the codes	10.83 - 10.93
SUMMARY	10.94

Chapter XI The Marketing of New Issues

Introduction and objectives	11.1 - 11.3
Background	11.4
Protection of Investors Ordinance	11.5 - 11.7
Securities Ordinance	11.8 - 11.13
Companies Ordinance	11.14 - 11.20
Securities (Stock Exchange Listing) Rules	11.21 - 11.26
SEHK rules and role	11.27 - 11.33
Problems	
Private placements	11.35
Professional investors exemption	11.36 - 11.38
Sections 72 to 74 of the Securities Ordinance	11.39
Companies Ordinance control of offers to the public	11.40
A review of the statutes	11.41 - 11.44
Duplication of effort	11.45 - 11.61
Summary	11.62 - 11.64

Chapter XII Continuing Obligations of Listed Companies

Introduction and objectives	12.1
Background - the SEHK Listing Agreement	12.2 - 12.7
Accounting information	12.8 - 12.11
Material shareholdings	12.12 - 12.13
Director's dealings	12.14 - 12.16
Major and related-party transactions	12.17 - 12.21

Chapter XIII Other Areas

Introduction	13.1
(A) Review of legislation covering the securities industry	13.2
(B) Insider trading	13.3 - 13.6
(C) The Hong Kong Code on Takeovers and Mergers	13.7 - 13.11
(D) Margin trading	13.12 - 13.15
(E) The role of trade associations	13.16 - 13.18
(F) Second market	13.19 - 13.24
(G) Insurance coverage for Exchange members	13.25
(H) Brokers' commission	13.26
(I) Compensation Fund	13.27
(J) Developing the Hong Kong debt market	13.28 - 13.37
(K) Market linkages	
Asymmetry in futures market	13.41 - 13.42
Margins	13.43 - 13.49
Trading halts	13.50 - 13.55
Co-ordinated clearing and surveillance	13.56 - 13.57
The development of new derivative markets	13.58 - 13.60
(L) Supervision of diversified firms	
Functional versus institutional supervision	13.62 - 13.65
Dual authorization and supervisory overlap	13.66 - 13.70
Consolidated supervision	13.71
International co-operation	13.72 - 13.73
(M) A Financial Services Commission	13.74 - 13.79

Appendices

	<u>pages</u>
1. The closure and subsequent events	349 - 354
2. Membership of the Securities Review Committee	355
3. Representations received	356 - 360
4. Overseas institutions visited by the Securities Review Committee	361 - 362
5. Overseas organisations not visited by the Committee which have assisted its work	363
6. A list of technical discussions held	364
7. A list of formal meetings held	365
8. Comparison of the world's major equity markets	366
9. Views of international investors on the Stock Exchange of Hong Kong - Summary of Burson-Marsteller's study carried out for the SEHK	367 - 370
10. Development of the securities industry in Hong Kong	371 - 376
11. The Stock Exchange of Hong Kong - Market capitalisation by sectors at end 1987	377
12. The Stock Exchange of Hong Kong - Income for the year ending 30 June 1987	378
13. The Stock Exchange of Hong Kong - Numbers of individual and corporate members (April 1986 to April 1988)	379
14. Relative contribution of individual and corporate members to stock market turnover by value (April 1986 to April 1988)	380 - 381
15. Sub-committees of the Stock Exchange of Hong Kong	382
16. Rule 226 of the Stock Exchange providing for specific powers of the Chief Executive	383 - 384

17.	Summary of the management proposals of the Stock Exchange of Hong Kong (1988)	385 - 388
18.	Report of the listing rules and procedures of the Stock Exchange of Hong Kong - Summary of recommendations	389 - 390
19.	The Stock Exchange of Hong Kong - Suspension of listings (April 1986 to March 1988)	391
20.	Interim measures to mitigate settlement and registration problems suggested in the submissions to the Securities Review Committee	392
21.	Stock index futures	393 - 398
22.	History and development of the Hong Kong futures market	399 - 404
23.	The Hang Seng Index market	405 - 420
24.	The Hong Kong Futures Exchange - Reforms for futures trading in Hong Kong	421 - 423
25.	Regulatory framework of the securities and commodity futures industries in Hong Kong	424 - 431
26.	Proposed powers of the Securities Commission	432 - 434
27.	Authorised securities intermediaries (as at end November 1987)	435 - 437
28.	Examples of conduct of business rules	438 - 439
29.	Enquiries and complaints received by the Office of the Commissioner for Securities and Commodities Trading (2 January 1987 to 19 March 1988)	440
30.	Listing matters handled by the Office of the Commissioner for Securities (1983 to 1987)	441 - 442
31.	Proposed entry requirement for second market	443

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CHAPTER I

OVERVIEW

Background

1.1. 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.

1.2. Hong Kong was not immune, falling 11.1% on 19 October alone, but its experience of the October crash was nevertheless unique⁽¹⁾: 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⁽²⁾ 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

(1) The events of October 1987 are discussed in detail in Appendix 1.

(2) 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.

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(3).

1.3. 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.

1.4. 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(4). Unfortunately, neither the market infrastructure nor the regulatory systems kept pace.

1.5. It was against this background that we were appointed by the Governor on 16 November 1987(5) 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.

(3) In the event this second \$2 billion was not needed.

(4) Measured in numbers of contracts traded; it was relatively much smaller in terms of the value of open positions, see para. 3.4 below.

(5) A list of the members of the Securities Review Committee is at Appendix 2.

Major criticisms

1.6. 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"(6), 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.

1.7. 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 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

(6) 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.

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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 re-vamped Hong Kong Futures Exchange⁽⁷⁾, 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;

(7) It was relicensed in 1984 after an earlier crisis and subsequently reorganised.

(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 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

1.8. 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

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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.

1.9. 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.

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

1.11. In the chapters which follow, we set out our general principles and major objectives against the background of the present state of the Hong Kong markets and how we see their development. We then address in turn the various problem areas identified in the Stock Exchange, the Futures Exchange, the two Commissions and the Office of the Commissioner.

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CHAPTER II

PROCEEDINGS OF THE COMMITTEE

Terms of reference

2.1. On 16 November 1987, we were appointed by the Governor with the following terms of reference : -

"In the light of recent events in the Stock and Futures Markets and in recognition of the need to maintain Hong Kong as a major international financial centre, to review the constitution, powers, management and operation of : -

- (a) the Hong Kong Stock and Futures Exchanges;
- (b) the Securities and Commodities Trading Commissions; and
- (c) the Office of the Commissioner for Securities and Commodities Trading,

and to recommend what changes are desirable to ensure the integrity of the markets and to protect investors."

2.2. In addition, we were asked to act in accordance with the following directions : -

- "(a) it should invite submissions from all interested parties and from the public;

(b) its object is to examine critically the relevant structures and systems rather than to allocate blame or find fault with named individuals or institutions for past events;

(c) it should consider comparable arrangements in other major financial centres; and

(d) it should use its best endeavours to submit its report within six months; the Committee shall have the power to make such interim recommendations as it considers necessary in the interests of the urgent protection of investors."

2.3. The Committee held 15 private meetings in the course of its work.

Modus operandi

2.4. At our first meeting on 23 November 1987, we agreed that the Committee's programme of work should broadly be divided into four main stages, namely : -

Stage I- invitation of submissions from interested parties and the public and collation of background information, both locally and overseas;

Stage II- identification of main issues;

Stage III- discussions with interested parties and principal respondents; and

Stage IV - preparation of the report.

Apart from minor adjustments, such as extending the period for the submissions to reach the Committee, we proceeded in accordance with this programme.

Submissions

2.5. Following the directive to invite views from interested organisations and members of the public, we held a press conference immediately after our first meeting on 23 November 1987 to invite the major organisations involved in the securities and futures industry and other interested parties to put forward their views and suggestions in written submissions to the Committee.

2.6. Although an initial five-week period was allowed for respondents to send in their submissions, we decided to be flexible on the actual deadline for receipt of submissions to ensure that the Committee had before it the views of as many organisations and individuals as possible.

2.7. In response, a total of 115 submissions were received from 21 bodies, 64 companies, 26 individuals and four Government departments. Included among the respondents were all those bodies which fall within our terms of reference, the major organisations associated with the securities and futures industry in Hong Kong, the principal professional bodies of accountants, lawyers,

stockbrokers, securities analysts and company secretaries, and a substantial number of brokerage and fund management firms.

2.8. When we requested submissions from interested parties, we gave an undertaking that submissions received would be used solely for the purpose of the review and would be treated in strict confidence. We further undertook to refrain from quoting from the submissions without the author's written permission. For these reasons, we feel it inappropriate to append any of the submissions to this report. We have, however, obtained their permission to include in our report a list of all the respondents who made submissions to the Committee. This is at Appendix 3.

2.9. All the submissions received were carefully reviewed by us and where necessary, additional information or clarification was requested from the respondents. The views expressed in the submissions were summarised and catalogued and formed the basis of our consideration of the issues involved.

2.10. We were extremely encouraged by the volume of response and were particularly impressed by the quality of the submissions, the majority of which contain clear and detailed expositions on the Hong Kong stock and futures markets and put forward specific suggestions for improvements. We believe that we had before us a range of views representing all the sectors in the securities and futures industry. We would like here to express our gratitude to all those who put forward submissions to us.

Other overseas reports

2.11. In addition to the submissions received, we also had the benefit of the various reports on the market collapse produced by the Brady Commission appointed by the President of the US, the US Securities and Exchange Commission, the New York Stock Exchange, the US Commodities Futures Trading Commission, the US General Accounting Office, the Chicago Mercantile Exchange, the Chicago Board of Trade, the International Stock Exchange, London and the Bank of England. These provided useful adjuncts to our deliberations.

Overseas visits

2.12. To facilitate the Committee's consideration of the comparative arrangements in other major financial centres, the Chairman and members of the Committee's Secretariat visited the Exchanges and regulatory authorities in the UK, US, France, Japan and Singapore in the months of December and February. Members of the Committee also took advantage of their own private travel abroad to join in some of those visits and to establish contacts with the Exchanges in Australia. Appendix 4 contains a list of the overseas institutions visited by us.

2.13. These visits helped us to establish contact with overseas Exchanges and regulatory bodies which proved invaluable to our deliberations. Overseas experts provided not only essential information on developments in the world's major markets but also gave helpful advice on the steps that need to be taken if Hong Kong wishes to flourish as an international market. Moreover, they provided an essential sounding board to test our ideas and recommendations. Our many discussions with the overseas

experts have also provided the Committee with first-hand information about the reactions of overseas institutions and international investors to events in Hong Kong associated with the market crash in October 1987 and their overall perception of Hong Kong markets.

2.14. In addition to these visits, we have in the course of our work received assistance and information from a number of overseas organisations and institutions. These too contributed immensely to our work. A list of these organisations is at Appendix 5.

2.15. We would like here to express our gratitude to all those overseas institutions and their staff who have helped us in our work.

Identification of main issues

2.16. It became apparent to us from the very beginning that our terms of reference were extremely wide and, unless some priorities were determined, we would not be able effectively to discharge our responsibilities within our limited time-frame. We therefore began the second stage of our work by examining the Exchanges, the Commissions and the Commissioner's Office in the light of the market crash and, by reviewing the views expressed in the submissions, identifying the major issues which had to be addressed.

2.17. In doing this, we adopted as our starting point the needs of Hong Kong as an international financial centre. We believe that this mainly involves restoring confidence in Hong Kong's security markets by putting in train changes which will strengthen, deepen and broaden the markets.

2.18. We have carefully considered these issues and have put forward detailed recommendations as to how they should be dealt with. We have endeavoured in particular to identify those which, in our view, call for urgent remedial action. In respect of other issues brought to our attention in the course of the review, we have only had time to recommend certain guiding principles as to how these should be tackled. We strongly urge that further work should be undertaken by the Administration in these areas. Finally, there are a range of issues which, although important for the securities industry, are not critical to issues addressed by our report. We flag these for attention by others.

Meetings with interested parties

2.19. At the time of the call for submissions, we indicated a wish to invite some of the people who made submissions to give their views orally to us. Two separate series of meetings were conducted.

2.20. We met respondents in February in a series of discussions. These discussions were basically of a technical nature to facilitate our understanding of views contained in the respondents' submissions and to enable them to elaborate and amplify their comments. A total of 18 meetings were held and a list of the attendees is at Appendix 6.

2.21. Included in these were three discussion sessions with groups of brokers attending in their personal capacity under the auspices of the Hong Kong Stockbrokers Association.

2.22. These technical discussions were followed by a series of formal meetings held in March and early April. A total of 15 meetings were held with the major bodies, as listed at Appendix 7. These bodies are either the subject of our review or are key players in the markets in Hong Kong. We took advantage of the formal meetings to seek clarification or additional information concerning the submissions from the respondents, to obtain a second opinion on some of the issues raised by other respondents without attributing the sources, and to test the reaction of respondents to our preliminary conclusions on some of the issues involved.

2.23. In addition to the technical discussions and formal meetings, we met with prominent personalities in the securities and futures industry, both locally and overseas, to listen to their views. Unfortunately, it is not possible to list all the people whom we met and the organisations which have given support to our work. The wealth of information and views obtained from those discussions have made an invaluable contribution to our work and we would like to put on record our thanks to all those who devoted so much of their time to help us.

Visits to the major local organisations

2.24. The Chairman and members of the Committee's Secretariat also visited the Stock Exchange of Hong Kong Ltd., the Hong Kong Futures Exchange Ltd., the I.C.C.H. (Hong Kong) Ltd. and the Office of the Commissioner for Securities and Commodities Trading to obtain first-hand information on their operations and to discuss their work with them. In the course of our work, these organisations, in particular their senior management, have been most helpful and forthcoming and contributed immensely to the

successful completion of our task. We would like to express our deep appreciation to these organisations and their staff for their assistance and co-operation.

Format of report

2.25. We are aware that our report will be read by market practitioners, regulators and members of the public in Hong Kong and overseas in addition to the Administration to whom it is addressed. On those recommendations which we feel deserve urgent attention, we have therefore gone into considerable detail in order to facilitate implementation. The same applies to contentious issues which have been argued vigorously by the parties holding opposing views. We hope that the detailed exposition will enable readers to understand our thinking in arriving at particular conclusions.

2.26. Finally, we would like to stress that our review was not aimed at allocating blame or finding fault for past events. We would remind the reader that the main object of our work was to examine critically the relevant structures and systems and to build a blue-print for the future. Our report should be read in this light.

Acknowledgement

2.27. Our review and report could not have been completed without the help of our Secretariat headed by Mr Michael Wu assisted by Mrs Carrie Lam, Miss Au King-chi and other secretariat staff. In addition we are grateful to the Bank of England for seconding Mr Paul Tucker to us whose expertise and ideas have greatly assisted our work. We wish formally to record our gratitude for their hard

work and dedication without which it would not have been possible to prepare this report in as little time as six months. Furthermore, we wish to thank Messrs B P Clancy and G J McMahon from the Attorney General's Chambers who advised us on the legal aspects of our report.

CHAPTER III

OBJECTIVES AND PRINCIPLES

Introduction

3.1. 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.

3.2. 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

3.3. 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 capitalisation of all FIBV exchanges(1). It ranks 20th among all FIBV exchanges but is third after the two Japanese exchanges in Asia(2). The Hong Kong stock market is characterised by a particularly vigorous retail element.

3.4. 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(3) but

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- (1) 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.
- (2) A comparison of the Stock Exchange of Hong Kong with other stock exchanges is at Appendix 8.
- (3) The turnover of the following stock index futures contracts valued at the month end cash index for September 1987 was as follows :-

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

since the crash turnover has declined, with only 30-40,000 contracts currently being traded each month.

3.5. 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;
- (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⁽⁴⁾;
- (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.

(4) 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.

3.6. 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 DTC) Hong Kong dollar liabilities at end December 1987 were \$200 billion (US\$26 billion), while total inter-bank foreign currency liabilities on the same date amounted to \$2087 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

(5)
denominated in foreign currencies .
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(6). 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(7).

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

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

(7) Using the end of year price of US\$486 per troy ounce.

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

3.7. 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⁽⁸⁾ and has become an important base for China-related investment.

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

	<u>at 31st Dec 1987</u>
Banks ⁽⁹⁾	155
Deposit-taking companies ⁽⁹⁾	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

3.9. In summary, Hong Kong is neither a closed domestic market nor a fully-fledged international capital market in

(8) 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.

(9) 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.

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. 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

3.10. 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-a-vis China as it could fill a gap in China's financial infrastructure.

3.11. 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 markets 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.

3.12. 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.

3.13. 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.

3.14. 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⁽¹⁰⁾.

3.15. 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

(10) 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 for the key findings of this survey.

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

3.16. 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 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.

3.17. 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.

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

(a) **systemic stability.** The market should not be threatened by major market breakdowns, but if they do occur contingency measures should be available. Systemic stability is a particularly important objective in Hong Kong where the closure of the stock market and the collapse of the futures exchange struck right at the heart of the system. The need for systemic stability raises questions about the management of risk and capital adequacy;

(b) **orderly and smooth functioning market.** The marketplace should function efficiently and smoothly. Its operations should be regular and reliable. There should be price continuity in depth. Large and unreasonable price variations should not occur between consecutive sales; nor should sharp price movements occur without appropriate accompanying volumes. Dealing, settlement and price notification procedures should work smoothly without breaks or delays. This objective raises questions about mechanisms and relationships surrounding the market. Systems and procedures lie at the heart of the problem;

(c) **fair market.** The market should be free from manipulation and deception so that no unfair advantage accrues to any participant; and shareholders in a public company should be treated equally. This raises questions about price transparency and disclosure. Companies should promptly provide adequate information to enable investors to make informed decisions, bearing in mind the availability of securities analysts who should detect misleading statements and help to ensure that company data translates itself into appropriate price adjustments; and

(d) **protection of investors.** The doctrine of caveat emptor must remain important but should not be given free reign. The private investor must be protected against crooks and fools. This raises questions about entry standards for intermediaries (i.e. honesty and competence), self-discipline, surveillance and enforcement.

3.19. These objectives raise four issues, in order of priority : risk-management capability, the availability of effective systems, the adequacy of disclosure and arrangements for enforcement. All are addressed in later chapters.

The management of risk

3.20. Before we move on, however, we feel that, in the light of the events of last October, we should sound a note

of caution. We believe that it is wholly inappropriate to attempt to build a system with no fails. Markets will continue to gyrate, sometimes wildly, players will continue to fail and clients will continue to default. No free market system can, or indeed should attempt to, prevent such events from occurring. The important thing is to ensure that problems are localised and do not strike at the heart of the system, bringing about or threatening total or near total collapse of the market. The events of October illustrated the paramount importance of ensuring, as far as possible, that securities market crises do not spill over into other fields such as banking and money markets. It is therefore imperative that the risks inherent in the market are understood, properly spread and adequately managed.

3.21. 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

3.22. 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.

3.23. 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

3.24. We appreciate that so-called self-regulation may appear to have failed in Hong Kong. Nevertheless, we continue to recommend a practitioner-based system as the best available to meet our objectives for Hong Kong. We do so because we wish above all to avoid the danger of straight-jacketing the securities markets by a strict statutory regime which might all too easily lead to insensitive or heavy handed over-regulation. Laissez-faire has served Hong Kong too well for it to be abandoned altogether just because it has been ineptly used and grossly abused.

3.25. 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.

3.26. 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.

3.27. 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.

3.28. 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

3.29. 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."(11)

3.30. 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."(12)

3.31. 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.

3.32. 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

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

(12) 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".

single statutory body. The statutory supervisor is thus the watch-dog, with the market handling the day-to-day supervision and regulatory tasks.

3.33. 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.

3.34. 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.

3.35. 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

3.36. 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

3.37. 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.

3.38. 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.

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

3.40. 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.

3.41. 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.

3.42. This then is the strategy we propose for Hong Kong security markets. In the following chapters we examine each of the bodies involved : the Stock Exchange, the Futures Exchange and their supervisors - the two Commissions and the Commissioner's Office.

CHAPTER IV

THE STOCK EXCHANGE CONSTITUTION AND MANAGEMENT

Background

4.1. Although trading in equities has a long history in Hong Kong, with the first stock exchange established in 1891⁽¹⁾, it only played a peripheral role in the development of the Hong Kong economy. The stock market is not used significantly for raising capital for the manufacturing sector which has been the main driving force behind Hong Kong's phenomenal growth⁽²⁾. It tends to be dominated by long-established firms outside the manufacturing sector - primarily banks, public utilities, trading companies and property firms. The under-representation of the manufacturing sector continues to be reflected in the structure of today's market. As at end December 1987, industrial shares accounted for only 6.38% of total market capitalisation⁽³⁾.

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- (1) An account of the development of the securities industry in Hong Kong is contained in Appendix 10.
- (2) The major reasons for the manufacturing sector not raising funds from the Stock Market are the small size of the average manufacturing firm, which makes public listing an uneconomic means of obtaining finance, the major role of banks in facilitating industrialisation by providing loans for fixed asset investment and a heavy dependence on money borrowed from within the family.
- (3) Market capitalisation by sectors for 1987 is at Appendix 11.

4.2. The Hong Kong stock market is essentially a small market in international terms and predominantly domestic in nature. As at end December 1987, there were 276 mostly local companies listed on the Stock Exchange of Hong Kong Limited (SEHK). Their total market capitalisation was \$420 billion, accounting for less than 1% of world market capitalisation⁽⁴⁾. A considerable number of the listed companies are family businesses with both ownership and management controlled within the family. Analysis at end March 1988 showed 10 families controlled companies representing 54% of the Hong Kong market capitalisation.

4.3. While the Exchange has not been a major avenue for raising capital for the development of industrial enterprises, it has attracted small local investors⁽⁵⁾. Members of the public have a good general knowledge of stocks and shares and small investors contribute significantly to liquidity in the market.

4.4. Overseas institutional investors' interest in the Hong Kong stock market is fairly recent. Prior to 1986, the existence of four exchanges⁽⁶⁾ hampered market development, in particular the development of consistent rules and practices among the exchanges, and affected international confidence in the market. The unification of

(4) See Appendix 8.

(5) As at 30 April 1988, 41% of the shareholders on the books of the largest company registrar in Hong Kong held 2,000 shares or less.

(6) The four stock exchanges were the Hong Kong Stock Exchange, the Far East Stock Exchange, the Kam Ngan Stock Exchange and the Kowloon Stock Exchange.

the four Exchanges in 1986 brought about a new era in share dealing in Hong Kong(7).

4.5. In addition, Hong Kong has witnessed a very rapid growth in the development of unit trusts, pension funds and life insurance in recent years, thus bringing to the market a burgeoning group of local institutional investors. The total number of authorised unit trusts and mutual funds increased from 88 at end 1982 to 266 (or 504 if sub-funds were included) at end 1987. An industry survey covering 290 of the 500 odd funds put total assets as at 31 March 1988 at \$73 billion (US\$9.4 billion). The number of approved retirement schemes increased from 2588 at 31 March 1982 to 5469 at end 1987 with assets of about \$50 billion (US\$6.4 billion). We have been told by the Life Insurance Council that the number of life policies increased by 45.6% in 1986 over 1985. However, life insurance companies and pension funds have told us that the lack of medium or long term marketable debt instruments in Hong Kong and the volatility of the local stock market has caused them to look overseas for much of their investment.

4.6. Since unification, average daily turnover has increased from a pre-unification average for all four exchanges combined of around \$250 million to \$1.1 billion. Turnover reached dramatically high levels, averaging \$3 billion to \$4 billion a day, in the period immediately preceding the October crash.

(7) After nearly ten years of negotiation the four stock exchanges were unified in 1986 and the Stock Exchange of Hong Kong Ltd. was recognised by the Securities Commission under S. 3 of the Stock Exchanges Unification Ordinance (Cap. 361) to have the exclusive right to establish, operate and maintain a stock market in Hong Kong. It commenced operation on 2 April 1986.

4.7. The transformation of the market from an essentially domestic market into one assuming international attributes came at a remarkably quick pace. With uniform dealing practices and listing rules and the introduction of computer assisted trading, the SEHK attracted more business from international investors. Corporate brokers, who were for the first time formally admitted as members of the Exchange, took their share of turnover from 20% at the opening of the Unified Exchange to 57% in April 1988. Although there is no available information on the amount of trading attributed to international investors, the contribution of corporate members of the SEHK is a reasonable reflection of their involvement. Nevertheless, corporate members, many of whom are part of the international brokerage community, do a great deal of their business on behalf of local clients.

4.8. The metamorphosis of the past couple of years has placed great demands on the structure, operation and regulation of the market. Developments in market practices and the regulatory framework seriously lagged behind the growing activity. The safeguards and changes necessary to ensure market integrity were not in place when the market crashed in October 1987.

Objectives for the Stock Exchange

4.9. In Chapter III, we laid emphasis on Hong Kong's objectives including the internationalisation of its markets. We argued for a properly supervised market-based regulatory regime that would efficiently and effectively regulate the market and enhance the international status of Hong Kong. We saw the role of the Stock Exchange to be the day-to-day supervision of the market and its members. To ensure that the SEHK does this properly, we suggested that there should be adequate checks both against the

possibility of abuse by insider regulation and against the SEHK falling down on its job. We argued that, apart from the general supervision by the statutory watchdog, this involved a clear separation of policy and executive functions within the Exchange. We strongly advocated a professional, independent and well-qualified Exchange staff as a key element in ensuring that the SEHK undertook its regulatory responsibilities seriously. We further suggested that a proper balance of interests in the Exchange structure is necessary to ensure that it broadly represents the interests of all its members and users. In this chapter we shall consider the constitution, management and membership of the SEHK and our recommendations are guided by these objectives.

CONSTITUTION

Status of the Exchange

4.10. The SEHK was incorporated under the Companies Ordinance as a private company with limited liability. It was recognised by the Securities Commission under the Stock Exchanges Unification Ordinance as the sole exchange with the exclusive right to establish, operate and maintain a stock market in Hong Kong.

4.11. Although the Stock Exchanges Unification Ordinance contains specific provisions governing the relationship between the SEHK and its regulatory bodies⁽⁸⁾, the

(8) The Stock Exchanges Unification Ordinance recognised the Memorandum and Articles of Association of the Exchange Company (S.3). Such recognition may be withdrawn if the Exchange Company fails to comply with a list of requirements (S.36). The Commission may direct an amendment to the SEHK Rules (S.34). There can be no amendment to the Memorandum and Articles of Association or of the Rules of the Exchange unless approved in writing by the Securities Commission (S.35).

Exchange remains basically a private corporation. This has allowed the SEHK management to be dominated prior to the October crash by a small group. We found this situation most unsatisfactory given the Exchange's monopoly position in the securities industry in Hong Kong and its self-regulatory role. We have therefore carefully examined what status the SEHK should have in the light of the role and objectives we have set for it.

4.12. One suggestion considered by the Committee was to turn the Exchange into a public statutory corporation to reflect its monopolistic role. The new public body would remain a membership organisation and would continue to be self-governing; its powers, duties and constitution would be laid down in a statute and there would be a degree of Government control. Such a measure would entail winding up the SEHK and creating a new public body, under statute, to operate a stock exchange in Hong Kong. This raises questions about title to the existing assets and operating systems of the SEHK which could cause delays. We therefore decided against such an approach.

4.13. We are, however, of the view that the Exchange should operate as a public utility because it provides an important service to the community. It must act in the interests of members, investors and issuers alike and should be accountable not only to its shareholders but also to the investing public.

4.14. We believe that the present statutory framework for the SEHK already goes some way towards providing for the proper management of its affairs. Our recommendations in respect of the internal constitution and management of the SEHK later in this chapter will develop these provisions and ensure that the Exchange is operated as a public utility.

4.15. We believe however, that while the SEHK should remain a private company, there should be one important change : to its profit-making status.

4.16. At present, the Exchange Articles contain provisions which allow the distribution of profits to shareholders, although, in practice, there has been no such distribution. The SEHK's income for the year ending 30 June 1987 was \$166 million (US\$21.3 million), well above its operational needs, giving it a surplus after taxation of \$93 million (US\$11.9 million). The principal sources of the Exchange's income are the transaction levy, membership dues, and charges for listing and other services; with the bulk coming from the transaction levy of 0.025% of the consideration for each contract note⁽⁹⁾.

4.17. When the transaction levy was first approved, the Securities Commission (SC) was strongly of the view that it should be clearly identified to investors as being for the purpose of meeting the Exchange's running costs and that it should not directly benefit the members. We support this view, particularly as the investor is already required to pay commissions to the Exchange members to cover their costs and profits.

4.18. Accordingly, we recommend that the SEHK Articles of Association should be amended to remove all profit provisions and to specify in clear terms that the SEHK is a non-profit-making company. We believe that this measure would go some way towards restoring SEHK's credibility and enhance its public image.

(9) A breakdown of the sources of income of the SEHK for the year ending 30 June 1987 is at Appendix 12.

4.19. We have been assured by the SEHK Management Committee that they share this view and that they have no intention of declaring dividends. The Management Committee, however, stressed that the substantial surplus from the transaction levy should remain available for the further development of the settlement system and for its Fidelity Fund. We share this view.

4.20. We considered the possibility of pegging the transaction levy at a level which would only allow for the recovery of justifiable operating expenses so that no surplus would accrue. We rejected such a course of action because : -

- (a) the Exchange should be allowed to build up a reserve fund to tide it over difficult times, to finance improvements in services and to re-invest in new capital equipment;
- (b) it will require a significant increase in expenditure to strengthen its supervisory role and to improve its settlement system; and
- (c) the transaction levy should not be subject to frequent revisions, confusing the public.

Constitution of the Exchange

4.21. The SEHK's constitution is determined by three documents : -

- (a) the Stock Exchanges Unification Ordinance;
- (b) the Memorandum and Articles of Association of the SEHK; and

(c) the Rules of the SEHK.

The following paragraphs address in turn the problems that have arisen regarding its governing body, management and membership.

The governing body

4.22. Section 10 of the Stock Exchanges Unification Ordinance stipulates that the management and control of the Exchange is vested in a Committee to be elected by the shareholders. The SEHK's Articles of Association provide that the Committee shall consist of not less than 12 and not more than 21 members, and that the Committee shall have a Chairman and five Vice-chairmen. The Committee may exercise all such powers and do all such acts as may be exercised by the Exchange. It is also empowered to establish sub-committees to undertake some of these tasks and to delegate any of its powers to any person and any sub-committee.

4.23. At each Annual General Meeting, one-third of the Committee members retire from office but are eligible for re-election. Vacancies are filled by a ballot of members on the basis of one share one vote⁽¹⁰⁾. Every member is entitled to nominate or second candidates for election

(10) The SEHK Articles provide that a member may hold more than one share. The shareholding pattern of the Exchange as at 19 May 1988 was : -

<u>No. of shares held by a member</u>	<u>No. of members</u>	<u>Total no. of shares</u>
One	654	654
Two	73	146
Three	23	69
Four - Nine	12	61
	<u>762</u>	<u>930</u>

and to vote. Corporate members are, however, ineligible to stand for election⁽¹¹⁾. In a Committee election each valid ballot must include as many votes as there are vacancies with one vote per candidate. Election of the Chairman and Vice-chairmen is by secret ballot of the Committee. The Committee member receiving the highest number of votes is elected Chairman and the five candidates receiving the next highest number of votes are elected Vice-chairmen.

4.24. The current Committee, comprising 21 members, was elected by the Annual General Meeting in December 1987. On 2 January 1988, following actions by the Independent Commission Against Corruption concerning the former Exchange Chairman and others, the Committee, by a resolution, delegated all its powers to a Management Committee. The Management Committee is composed of 14 members of the Committee.

4.25. The principal complaints raised in the submissions about the constitution of the SEHK Committee were : -

- (a) by formally excluding corporate representation, the Committee did not adequately represent all the sectors of its membership, particularly as the corporate members account for more than half the Exchange's business;

(11) When corporate membership was introduced at the time of unification, there was concern among the members of the four exchanges that their admission could result in a relatively small number of influential and internationally based corporations dominating the SEHK. The bar against corporate members being elected to the Committee was one of two limitations introduced to meet this concern. The other restriction, in respect of bank-related brokers, was removed on 1 October 1987.

- (b) as elections to the Committee are on the basis of one share one vote and the SEHK's shareholders were predominantly individual members, corporate members had little chance of getting elected to the Committee even if the bar against them was removed; and
- (c) the presence of strong personalities on the Committee and their predominance over the rest of the Committee meant that, in the absence of a counterbalancing independent element, the SEHK had been run largely as a private club rather than a public utility.

4.26. We agree that the constitution of the current Committee is too narrow and is insufficiently representative of the marketplace. Unless it is substantially reformed, we see little prospect of the SEHK truly becoming a "public utility" serving the community at large and regaining the confidence of local and international investors and users. The key to reform is we believe to be found in the concept of balance by which the interests involved in the Exchange - members, investors and issuers - are all represented, to an appropriate degree, on its Committee.

4.27. We have, therefore, given considerable thought to improving the situation. After careful consideration, we established the following objectives for the composition of the SEHK's governing body : -

- (a) to maintain, as far as possible, the right of the SEHK membership to choose its own governing body;

- (b) the governing body to comprise a balanced slate broadly representative of the marketplace with an appropriate level of professional expertise;
- (c) reforms to resolve the current problems and to be sufficiently durable and flexible to accommodate foreseeable developments in the operation of the securities industry; and
- (d) as far as possible to obtain broadly-based support within the financial community.

4.28. Our first recommendation is that the name of the SEHK governing body should be changed from "Committee" to "Council". The former suggests a body which is actively involved in the day-to-day administration of the Exchange, whereas we believe that the governing body should be responsible for general policy and strategy, leaving management and execution of policy entirely to the Chief Executive and his staff. The change of name would give notice of this development and help to institute the principle of the separation of policy and executive functions within the Exchange.

4.29. In our view, the principal elements to secure a Council which would achieve the above objectives are : -

- (a) corporate representation;
- (b) appointment of independent members;
- (c) inclusion of the Chief Executive;
- (d) a balanced composition; and

- (e) an election method involving the use of a Nominating Committee.

Corporate representation

4.30. At present, corporate members are ineligible to stand for election to the Council; as are their dealing directors⁽¹²⁾ unless they become SEHK members in their own right. Since unification, the number of corporate members has grown considerably : from eight at the time of unification in April 1986 to 98 in April 1988, accounting for about 13% of the members. In market terms, corporate members held 209 of the 716 active seats at end April 1988 and accounted for 57% of turnover by value during the month⁽¹³⁾.

4.31. Against this change in the profile of the market, the continued prohibition against corporate member representation on the SEHK Council appears to us to be both inequitable to a significant sector of its members and unhealthy for market development. We believe that if a balanced representation is to be achieved and the authority of the Council enhanced, it is clearly essential that representatives of corporate brokers should be allowed on the Council.

(12) A dealing director is defined as a director of a corporate member who, either alone or with others, actively participates in, or is directly responsible for the supervision of, the corporation's business of dealing in securities. Every dealing director must be a registered dealer. Furthermore, he must be approved by the SEHK and his name entered in the Register of Dealing Directors. Only dealing directors may act as representatives of corporate members at SEHK General Meetings.

(13) The numbers of individual members and corporate members and their respective contribution to market turnover for the period April 1986 to April 1988 are contained in Appendices 13 and 14.

4.32. There has been much debate as to how corporate members should be represented on the Council. Those who support the existing arrangements argue that representatives of corporations can obtain election to the Council by purchasing an extra share in the Exchange hold it as an individual and secure election to the Council in that capacity. They point out that this is the position of four members of the existing Management Committee.

4.33. We do not support such a method mainly because we believe corporate members should be represented on the Council as a matter of principle. They should not be forced to secure representation through a subterfuge as it suggests, first, a lack of merit in the case for such representation and, second, the condoning of an arrangement aimed at getting round existing rules. The second reason is, in our view, particularly objectionable.

4.34. We therefore recommend that the SEHK Articles of Association should be amended to remove the bar against corporate representation on the Council. This would give all members a chance of being represented.

4.35. We do not, however, propose to disturb the existing general bar against companies becoming members of the Board of Directors of any private company because first, it is a general principle of Hong Kong company law⁽¹⁴⁾ and second, because it is important that those elected to the Council should serve by virtue of their knowledge, expertise and familiarity with Hong Kong and not simply as nominees of particular firms.

(14) In some jurisdictions, directors of companies may themselves be companies as opposed to individuals. This is not the case in the UK or Hong Kong.

4.36. We accordingly recommend that directors of corporate members should be eligible to stand for election. This is not difficult to achieve as the current Exchange arrangements already provide for the registration of dealing directors of corporate members and for them to participate in the SEHK General Meetings. However, we believe that no single corporate member should have more than one director on the Council. Moreover, such directors, once elected to the Council, should serve in their personal capacity. It follows that they should remain on the Council even if they leave the corporation from which they first derived their eligibility to be elected, provided that they continue to participate in the business of dealing in securities and remain in the employ of a member or become individual members of the Exchange.

4.37. We note that removal of the prohibition alone would not necessarily result in corporate members being elected to the Council. This is because individual members are still in a clear majority and they may collectively out-vote any corporate member candidates. A solution to this problem is to prescribe the composition of the Council. This is considered at para. 4.43.

Appointment of independent members

4.38. To ensure that the Exchange will be operated as a public utility representing the whole spectrum of interests involved in the securities industry, we believe that there should be non-brokers on the Council. They would act as a safeguard against the Council taking decisions which are in the interests of brokers but not of the marketplace as a whole. The independent members should include users of the market - at least one senior officer of a listed company and one fund manager - together with prominent community leaders

representing the investing public. All should be ordinarily resident in Hong Kong. We therefore recommend that there should be non-brokers on the Council, of whom at least one should be a senior officer of a listed company and at least one should be a senior officer of a fund management company.

4.39. We believe that to achieve the effect we desire, such members should account for roughly 25% of the Council. This is less than the arrangements in other major equity markets. For example, the New York Stock Exchange has 12 public and 12 industry representatives.

4.40. As regards the method of appointing independent members, we considered the option of appointment by the Government. Although this option attracted a number of protagonists, we have dismissed it for two reasons : the SEHK members should bear the first responsibility for electing their own Council; and the experience of October 1987 has, we believe, confirmed the inadvisability of the Government becoming too closely involved in directing the SEHK affairs⁽¹⁵⁾. We therefore recommend that independent members should be co-opted by the SEHK Council after consultation with the regulatory authority. The requirement for prior consultation with the regulatory authority should, together with the enhanced powers for the regulatory authority proposed in para. 4.68, eliminate the risk of the Council choosing unsuitable candidates.

Inclusion of the Chief Executive

4.41. In para. 4.9, we stated that one of the fundamental principles of our reform proposals is the separation of

(15) As a transitional measure, however, we believe that the Government does have a role to play (see para. 4.67 below).

policy from execution, we accordingly believe that the Chief Executive has an important independent role to play in the operation of the SEHK. He should undertake the following functions : -

- (a) ensuring the orderly operation of the market;
- (b) ensuring the integrity of the market through adequate regulation of members, listed companies and the trading floor;
- (c) preserving the independence of the executive in the discharge of its regulatory functions; and
- (d) managing the Exchange staff and resources.

4.42. While he will be an employee of the SEHK appointed by the Council, we recommend that the Chief Executive should be a full voting member of the Council. This will give him a proper place at Council meetings and enhance his prestige and independence, thereby narrowing the gap between the Council and the executive staff.

A balanced composition

4.43. Having identified the need to include in the Council corporate members, independent members and the Chief Executive in addition to individual members who currently dominate the Council, we now consider how to achieve a balanced Council.

4.44. We reject the idea of the Government appointing all the members of the Council on the grounds we mentioned

earlier, namely that it would represent an unnecessary and undesirable level of continuing interference in the internal affairs of the SEHK. Similarly, we reject the idea of confining our proposal to a simple requirement that the SEHK Articles should stipulate that the Council be "broadly based and representative of the market". Although such an article is needed this would not be enough in itself to ensure representation on the Council from a broad range of interests given the relative voting strength of the individual members.

4.45. We have, therefore, examined further ways of ensuring a balance and gave considerable thought to the best way of identifying the different groups in the membership. The alleged division between local and foreign brokers is in our view unreal because the largest broker⁽¹⁶⁾ in Hong Kong is Sun Hung Kai and Co. Limited, a locally based, incorporated, Chinese broker, and two of the four brokers immediately below that in size are associated with the Hongkong and Shanghai Bank and Jardine Matheson, both of which are local institutions. In fact, the most important division lies between the small brokers who serve the local retail investors and the large brokers who serve the international and institutional investors as well as a large number of retail customers. Lacking the means clearly to define large and small brokers and being of the view that such a definition would also be divisive, we reached the conclusion that the only relevant division is that between corporate and individual members.

(16) measured in terms of volume of shares traded for the first four months of 1988.

4.46. An obvious option is to divide the membership into two classes and assign a number of Council seats to each. Each section would elect its own members. But such a rigid division in the membership would exacerbate differences and might damage relations among members. It would have the further disadvantage of inflexibility at a time when the composition of the SEHK membership is changing : it could be the case that, as in other centres, corporate members might eventually find themselves in the majority. Certainly many local brokers have incorporated in the last year⁽¹⁷⁾.

4.47. We prefer not to divide the membership into two but instead to reserve certain seats on the Council. In elections all members would vote for all places.

4.48. We therefore propose that a specified number of Council places are reserved for individual members and corporate members (hereinafter referred to as the "reserved places") with the remainder of the elected places being filled freely by SEHK members (hereinafter referred to as the "floating places"). Apart from ensuring a balanced slate broadly representative of the market, this approach, through the provision of floating places, has the advantage of being sufficiently flexible to reflect future developments in the marketplace. With the exception of the Chief Executive, who should be on the Council ex officio, and the independent members, who should be co-opted by the Council with full voting rights, both the reserved and floating places should be elected by all SEHK members subject to the recommendations in respect of the voting system which follow.

(17) Since May 1987 the number of incorporated brokers has grown from 64 to 98.

4.49. We therefore recommend that the Articles of the SHEK should be amended to require that the Council be broadly based and representative of the market and that the proportion of representation in the Council should be : -

- (a) eight reserved places : four each for individual and corporate members put forward by a Nominating Committee and elected by members of the SEHK;
- (b) eight floating places to be filled by individual or corporate candidates nominated by members or (in due course) a Nominating Committee and elected by members of the SEHK;
- (c) five co-opted independent members of whom at least one should be a director of a listed company and one a fund manager; and
- (d) the Chief Executive - ex officio.

This would bring the membership of the Council from the present 21 to 22 members to accommodate the Chief Executive. We see no reason for any other change in the size of the Council. If, in the future, the size of the Council were to change the proportional balance should remain the same.

The Nominating Committee

4.50. Our review of other Exchanges has highlighted the difficulty which many have in securing good candidates to serve on their Councils. The difficulty is increased where there is a requirement, as there will be in Hong Kong, that

the Council should be broadly representative of interests in the market. We do not believe that it is appropriate to leave the nomination of candidates to chance. Furthermore, it might be divisive to encourage the formation of sectional interest groups representing individual and corporate brokers which could put forward candidates. We therefore propose that a special independent committee composed of members who would not themselves be candidates for election, should identify a group of eligible candidates.

4.51. We therefore recommend that the candidates for the reserved places should be nominated by a Nominating Committee. In order to provide an element of choice, the Nominating Committee should put up more candidates than places (in the ratio of three candidates for every two vacancies). In the longer term, we believe that the Nominating Committee should also put forward candidates for the floating places because we expect that, as is the case in other countries, members might not be willing to serve on the Council and a formal means will be needed to encourage candidates to come forward.

4.52. We recommend that the Nominating Committee should comprise six members appointed by the Council : three members of the Exchange who are not on the Council and not standing for election, including at least one corporate and one individual member; and three non-members, two of whom should be independent members of the Council. The Chairman of the Nominating Committee should be elected by the Nominating Committee from amongst the three non-members. The Nominating Committee should be serviced by SEHK staff.

4.53. In order to select the right candidates, we expect the Nominating Committee to canvass views widely. Suggestions should be sought from members of the market.

The Nominating Committee should provide full descriptions of the candidates to enable voters to know the qualifications and experience of those proposed for election.

The Chairman and Vice-chairman of the Exchange

4.54. Overseas experts have impressed upon us the central role of the Chairman of the Stock Exchange in the market, as the principal spokesman and representative, both locally and overseas, and as the person responsible for developing the market. We support such a role for the Chairman of the SEHK. To achieve these objectives, we recommend that the Chairman of the SEHK should devote a substantial proportion of his time to SEHK affairs in order to promote and develop the market.

4.55. It is, however, important that the Chairman should not get involved in the day-to-day administration of the SEHK; he should chair the Council and offer support and, where necessary, guidance to the Chief Executive.

4.56. To ensure that he commands the necessary trust and respect of the Council, we recommend that the Chairman should continue to be elected by the Council from within the Council. As the reconstituted Council will include brokers and independent members, the possibility of the Exchange Chairman being a non-broker exists. We strongly believe that the first Chairman should be an independent member but thereafter he could be a broker or an independent member of Council; the rule should be the best man for the job.

4.57. At present, the Council has five vice-chairmen⁽¹⁸⁾. We believe this is far too many and weakens the position of vice-chairman. We therefore recommend that the number of vice-chairmen should be reduced to two, both elected by the Council from within the Council. One should be a broker and one an independent member if the Chairman is a broker.

Voting arrangements

4.58. A number of submissions suggest a weighted voting system based on volume of business, capitalisation or the number of registered dealers in the company - to give due regard to the relative contribution of the different categories of members. We feel that with our proposed reserved places arrangement, it is unnecessary to amend the present one-share-one-vote system.

4.59. We believe that among the major flaws in the present voting arrangements are the collection of proxies and the position of shareholders who are not trading members of the SEHK. We believe that elections to the Council are sufficiently important for members to make their own choice and think it wrong that they should delegate their choice by a system of proxies especially where the proxy is a nominator or a Council member. We therefore recommend that election should be in person by secret ballot and subject to vetting by independent scrutineers.

(18) This is no doubt a relic of pre-unification negotiations.

4.60. We are concerned that almost a quarter of voters are not actually trading in the market⁽¹⁹⁾. Since the main objective of the Council is to run a healthy and fair market for users and intermediaries, and not to make profits for shareholders, we are in favour of excluding non-trading members from voting in Council elections.

4.61. To rectify the situation, we considered two alternatives : disqualifying non-trading members, so that they would cease to be shareholders of the Exchange; and suspending their Council election voting rights. We are inclined to the second in view of the arguments against depriving shareholders of their rights and for preserving the opportunity to resume trading at a later stage. Moreover, we believe the first route, because of its draconian nature, is likely to provoke non-trading members to resume trading on a marginal basis purely to retain their shareholders' rights. Accordingly we recommend that the SEHK Articles should be amended to withdraw the right to vote in Council elections from members whose trading licence has been suspended. As discussed in Chapter X below, we propose that the regulatory agency should promptly suspend the licences of registered securities intermediaries who have ceased to trade.

4.62. We see no need to change the other electoral arrangements whereby : -

- (a) a voter shall have a number of votes equal to the number of vacancies to be filled and must cast all his votes;

(19) As at end December 1987, there were 199 non-trading members holding between them 204 shares. Of these, 191 were individual members holding 195 shares and eight were corporate members holding nine shares. Shares represented 22% of votes.

(b) elections shall be conducted on a first-past-the-post system except that the eight places reserved for individual and corporate members must be filled by candidates nominated by the Nominating Committee. The failed candidates for the reserved places should be allocated floating places if they secure more votes than other floating place candidates; and

(c) the election arrangements should be approved by the regulatory body including the appointment of the independent scrutineers.

4.63. Similarly, we do not propose to alter the present arrangement of a three-year term for Council members and the retirement of the longest serving one-third each year. With the exception of the Chief Executive, we believe that there is a strong case for limiting the number of consecutive years a person may sit on the Council. Accordingly, we recommend that, after serving two terms, that is a total of six consecutive years, a Council member should step down for one or two years before standing for re-election.

4.64. We recommend that the Chairman should continue to be elected for a one-year term. To prevent a single person dominating the Council, he should serve a maximum of three years after which he should retire from the Council and not be eligible for election to the Council thereafter⁽²⁰⁾.

(20) The proposals in paras. 4.63 and 4.64 would conflict were it desired that an incumbent chairman or vice-chairman should serve another term but he had already been a Council member for six years. In such a case, the Council should be able to waive the six years rule proposed in para. 4.63.

4.65. For the sake of simplicity, we recommend that members of the Nominating Committee should also be appointed for a term of three years, with one-third of the members retiring each year. We further recommend that, given the sensitivity of the Nominating Committee's task, a member should serve only one three-year term except that the first group of Nominating Committee members, some of whom will be required to retire after the first and second years, should be allowed to serve a second term.

4.66. The Chief Executive should occupy his place on the Council ex officio and not be subject to election or triennial retirement.

Transitional measures and permanent safeguards

4.67. Under our proposed system, the Council should become highly authoritative and independent. The integrity of the system and the success of the new arrangements depend, however, on ensuring the right Council to begin with. We believe that this is so important that the Government should play a direct role in the formation of the Council at the initial transitional stage. We recommend that, as a transitional measure, the first five independent members of the Council, the first Nominating Committee and the first scrutineers be appointed by the Governor. We believe that Government involvement in producing the first reformed Council would signal to both the local and international community that Hong Kong is seriously addressing the problems in the SEHK constitution.

4.68. After the first elections, the regulatory body⁽²¹⁾ should be responsible for ensuring the

(21) See Chapter IX for recommendations on the establishment of a new Securities Commission.

integrity of the system by resorting, where necessary, to a range of reserve powers. We recommend that the regulatory authority should : -

- (a) ensure that the Council is elected in accordance with the Articles which should require that the Council should be broadly based and representative of the market;
- (b) ensure that independent members appointed by the Council are genuinely independent;
- (c) ensure that all members of the Council, including the Chairman and the Chief Executive are fit and proper persons to hold office; and
- (d) have the power to approve the terms of reference of the Chairman and the Chief Executive.

While the regulatory authority should intervene in the Council elections if the above requirements are breached, we stress that these are reserve powers to be exercised only if the occasion warrants their use.

Summary

4.69. In summary, our main proposals to reform the constitution of the SEHK governing body are as follows : -

- (a) the name of the governing body should be changed from "Committee" to "Council";

- (b) the Council should have 22 members consisting of the Chief Executive ex officio, five independent members initially appointed by the Governor and thereafter by the Council, four reserved places each for individual and corporate members and eight floating places for either individual or corporate members to be elected by members of the Exchange;
- (c) a Nominating Committee, initially appointed by the Governor and thereafter by the Council, to put forward a balanced slate of candidates for the reserved places. The Nominating Committee should consist of three brokers and three independent members; and
- (d) voting should continue to be on a one-share-one-vote basis but should be in person by secret ballot and non-trading members of the SEHK should not be eligible to vote in the election.

4.70. We are aware that a voluntary amendment to the SEHK Articles to permit these changes would require the support of 75% of the members, and we have been told that such a degree of support might be difficult to obtain under the present circumstances. Legislation will, therefore, be required. Although the SC currently has the power under Section 34 of the Stock Exchanges Unification Ordinance to direct the SEHK to amend its rules, this does not apply to its Articles of Association. Were the Ordinance to be amended to give the SC power to impose changes, if necessary by unilateral direction, in the SEHK Articles the necessary alterations to implement our constitutional proposals could be achieved.

MANAGEMENT

Committee and sub-committees

4.71. Under the SEHK Articles, the Committee may delegate any of its powers to one or more sub-committees. These sub-committees may consist of Committee members or other SEHK members or the Secretary (but not the Chief Executive) as the Committee thinks fit. Members of sub-committees can be removed by the Committee.

4.72. The powers of sub-committees are subject to the overriding rights and powers of the Committee. Rule 204(4) of the Exchange provides that the Committee may vary, supplement or discharge, in whole or in part, any decision that may be reached by any sub-committee. As at 31 January 1988, there were 14 sub-committees(22).

The Chief Executive and staff

4.73. The Chief Executive is responsible for the day-to-day management of the SEHK and supervision of markets. The Committee may delegate to the Chief Executive such duties and powers as it thinks fit. Certain specific powers of the Chief Executive are listed in Rule 226(23).

4.74. The Chief Executive is responsible for the employment of staff (save for the Secretary and Treasurer of the SEHK). As at 31 January 1988, the SEHK had 234 employees (including the Chief Executive and Secretary) staffing 14 departments as follows : -

(22) A list of the current sub-committees is at Appendix 15.

(23) SEHK Rule 226 is reproduced at Appendix 16.

<u>Department</u>	<u>Staff</u>
Administration (including Secretarial)	10
Chief Executive's Office	4
Computer	40
General Affairs	16
International & Corporate Affairs	46
Listing	30
Membership	10
Members' Surveillance	15
Personnel	4
Printing	4
Property Management	21
Research	16
Settlement	7
Trading	<u>11</u>
Total	<u>234</u>

We note with concern that the SEHK did not employ any accounts or bookkeeping staff.

Major complaints

4.75. The principal complaints raised in the submissions regarding the SEHK management were : -

- (a) the elected office holders and Committee members took a direct hand in the day to day management of the Exchange rather than reserving themselves for policy matters;
- (b) its executive staff was too weak. Given the presence of strong personalities on the Committee as well as the sub-committees they were unable to discharge their functions independently;

- (c) the staff were insufficiently experienced to cope with the regulatory needs of a rapidly expanding and developing market;
- (d) the absence of an internal finance department meant that there was no formal system of budgetary and auditing controls within the SEHK;
- (e) the Committee exhibited a poor sense of management priorities. For example, of the 234 staff, 46 (or 20%) worked in the International and Corporate Affairs Department (the PR Department), while the Departments of Listing and Members' Surveillance had 30 and 15 staff respectively; and
- (f) the staff did not understand that their duty lay towards all SEHK members and users of the exchange and not just to members of the Committee.

Role of the key participants

4.76. We believe that the ability of the SEHK management to discharge its responsibilities is an essential ingredient of the two-tiered self-regulatory structure. Such responsibilities should include close market supervision and surveillance of members to ensure an orderly and smooth functioning market. In addition, the management should also discharge housekeeping functions efficiently, such as membership records, research, market development, accounts, personnel, public relations and accommodation.

4.77. To ensure that the key functions of management are properly discharged, it is essential to set out clearly the powers and responsibilities of the key participants and to draw a clear distinction between the formulation of policy and its execution. This aspect is particularly important in a membership organisation where the members may be eager to play a large part in the management of its affairs and where adequate checks and balances are of paramount importance to avoid conflicts of interest.

4.78. To this end, we recommend that the role and objectives of the key participants in the SEHK management should be clearly defined and made subject to the approval of the regulatory authority.

4.79. We believe the role of the key participants should be as follows : -

(a) the Chairman. He should be the figure-head for the SEHK and its principal spokesman. In addition to chairing the Council, he should set the tone, initiate policy proposals and have the vision to develop the market. He should also provide support and guidance to the Chief Executive;

(b) the Chief Executive. He should be the head of staff and, as such, should be in sole control of appointment and deployment of staff. Although he is a member of the Council and is the Council's principal advisor on policy matters, he should be independent, i.e. not a SEHK member.

While the Council has ultimate responsibility for policy matters, execution of policy is the responsibility of the Chief Executive and his staff;

- (c) members of functional and advisory sub-committees. They should recognise that they are not managing but providing policy guidance. Their responsibility is to provide input to policy and collectively to reach conclusions on policy proposals. The respective division heads, who work with the committees, should be responsible for executing policy.

4.80. We are aware that in large membership organisation there is always a class of decisions that fall between the formulation of policies and their application, for example, in applying policies to cases where an element of discretion or interpretation is called for. Such discretions include disciplinary matters and the approval of new members. Although the work is executive in nature, these tend to be handled by members' committees. We support members' involvement in these areas but stress that the members on such committees should take great care not to trespass on the role of the Exchange staff. Unless the executive staff are sufficiently insulated from potential interference by the Council or sub-committee members, they will be unable to discharge their functions independently and effectively.

The SEHK reform proposals

4.81. Following the October crash and the appointment of Mr Robert Fell as Senior Chief Executive, the SEHK has undertaken a series of studies of its management structure,

operations and staff requirements and has put in train a series of measures to strengthen and improve its management - in particular those areas such as listing, member surveillance and financial control which are in need of urgent improvement. The SEHK's management proposals can broadly be divided into five main aspects(24) : -

- (a) organisational improvements;
- (b) reform of the Listing Division;
- (c) strengthening surveillance capabilities;
- (d) establishment of a Finance Division; and
- (e) additional staff for the Operations Division.

4.82. We have considered SEHK's proposals in the light of our objectives for the SEHK and its key participants. In general terms, we support the measures proposed as they go a long way towards bringing the SEHK management up to required standards but we have the following reservations:-

- (a) **role of the Chairman.** The Exchange's proposals envisage the Chairman playing a largely ceremonial role. In view of our proposed objectives for the Chairman (see paragraph 4.54 above) and the advice of overseas experts, we recommend that the Chairman should be the principal spokesman for the SEHK; represent the SEHK at international and local levels; and be responsible for promoting the growth and development of the market;

(24) A summary of the proposals in each of the five areas is at Appendix 17.

(b) role of the Chief Executive. It is not clearly stated in SEHK's proposal that the Chief Executive should have ultimate responsibility for the appointment and deployment of staff. To further institutionalise the independence of the Chief Executive and to provide the necessary buffer between SEHK members and the staff, we recommend that powers over the appointment and deployment of staff be specifically vested in the Chief Executive under SEHK rules and that he should be clearly accountable to the Council for SEHK management and finances; and

(c) conflicts of interest. Because conflicts of interest often arise in membership organisations, there should be clear rules on declaring interests and excluding interested parties from decisions. The SEHK rules and the current proposals are silent in this regard. We believe it is insufficient to leave the issue to chance or to rely solely on the integrity of the participants to ensure that declarations and exclusions take place. We recommend that clear rules requiring the declaration of interests and the exclusion from decisions of those with interests be developed, preferably, as part of the SEHK rules. Furthermore, to ensure the independent role of some of the more important sub-committees, we recommend that the listing committee, the investigation committee and the disciplinary committee should include a number of non-SEHK members.

4.83. We stress, however, the need for the regulatory authority to monitor the situation closely to ensure that the improvements put in train are effectively implemented. Much will depend on the leadership qualities of the new Chairman, the new Chief Executive and the re-constituted SEHK Council. We recommend that the regulatory authority should review the SEHK management and controls within 12 months of its appointment. If it becomes clear that SEHK's management proposals have not been carried through, the regulatory authority should take the necessary action to ensure that they are implemented expeditiously.

MEMBERSHIP

Present situation

4.84. The SEHK Articles provide for two categories of membership : individual (i.e. natural persons) and corporate (i.e. companies limited by shares and incorporated in Hong Kong). Members may trade as sole traders or may form dealing partnerships (which may be limited partnerships) with other members or non-members.

4.85. Each member must hold at least one share in the SEHK, which entitles him to a seat on the exchange floor. While a member may hold more than one share (and hence more than one seat), shares may not be owned jointly. Shares are transferable in accordance with the rules of the Exchange. SEHK's authorised share capital is 1,200 shares of \$100,000 each, i.e. it can theoretically have a maximum of 1,200 members. As at 30 April 1988, there were 664 individual members and 98 corporate members, who between them held 930 shares and 716 seats.

4.86. Under the Stock Exchanges Unification Ordinance, only dealers registered under the Securities Ordinance are eligible to become SEHK members. Other conditions for membership are contained in the Securities Ordinance, the SEHK Articles and Rules. Broadly speaking, an individual member is required to be of good character and satisfy certain residence requirements while a corporation must be incorporated in Hong Kong, be of good financial standing and only carry on the business of dealing in securities and activities which are normally ancillary to a stockbroking business. They are also required to meet certain minimum net capital requirements and liquidity margins as contained in Section 65B of the Securities Ordinance and in the SEHK Rules. These are discussed in Chapter X below.

Major complaints

4.87. The principal complaints raised in the submissions regarding SEHK membership were : -

- (a) the number of SEHK members, relative to its size, was grossly disproportionate. This opened the possibility of fierce competition leading to undesirable trade practices. Another consideration was the burden posed on regulators in supervising so many members;
- (b) the existing rules regarding admission of members were inadequate because of the lack of emphasis on the quality of those being admitted. The SEHK rules basically reflect general club admission rules relying entirely on the dealer

registration system operated by the Commissioner for Securities to ensure quality. Moreover, it had never implemented its earlier undertaking to introduce an examination system for members and dealers. The Commissioner, on the other hand, adopted a generally permissive stance in the registration of dealers. The subject of authorisation of dealers is further discussed in Chapter X; and

- (c) the present net capital and liquidity margin requirements were inappropriate as they were inflexible and did not reflect the risks taken by individual members and their trading activities. The problem was compounded by the popularity and extent of margin trading, lax margin requirements and poor margin lending practices by some members which led to over-trading; this is further discussed in Chapter XIII below.

Non-trading members

4.88. The present number of SEHK members reflects a need to ensure that none of the members of the four exchanges was disenfranchised on unification. In considering the eligibility for voting in Council elections, we highlighted the position of non-trading members. We propose suspending their voting powers rather than depriving them of their share ownership. Similarly we believe that any attempt to impose a reduction on the number of members is inappropriate. Moreover, a strong counter-argument against such a course of action is the liquidity that the local brokers provide to the market. The general consensus

within the industry is that local brokers serve a useful function in the operation of the SEHK. Some are convinced that the local brokers played a pivotal role in the market in the events of October 1987⁽²⁵⁾. We therefore do not recommend any specific action to reduce the number of SEHK members. We believe that declining trading volumes, the tightening of rules regarding authorisation, the introduction of higher standards for newcomers and the movement towards incorporation will in time result in a natural wastage in the number of members.

Admission and training

4.89. On the admission and training of members, we recommend that the SEHK should take immediate steps to implement a training and examination system for members to ensure that they are knowledgeable in securities dealing, particularly in respect of the rules of the Exchange and the legislation governing the industry. In our view it would be inappropriate to require all existing SEHK members, some of whom already have many years of experience in securities dealing, to sit for an examination. The examination system should therefore be introduced for newcomers. In time, it should become a qualification for licensing as a securities dealer by the regulatory authority. There is also a need for a code of conduct to set out the standards and guidelines on professional conduct expected of members, this is considered in greater detail in Chapter X.

(25) It has been suggested to us that the heavy selling pressure by institutional investors after the crash of 19 October was absorbed almost entirely by the local brokers.

CHAPTER V

THE STOCK EXCHANGE

OPERATIONS OF THE MARKET

INTRODUCTION

5.1. In Chapter IV we discussed the constitution and management of the Stock Exchange of Hong Kong Limited (SEHK). In this chapter, after first discussing the major market question of short selling we review the operations of the Exchange under four headings : listing, dealing, settlement and surveillance.

SHORT SELLING

Background

5.2. Short selling refers to the sale of securities which the vendor does not own in the expectation that he can buy them back in the future at a profit. Delivery is usually satisfied by the short seller borrowing the shares; having covered his short position by a later purchase the borrowed securities can be returned to the lender. Short selling, which is legal in most major markets, affects the overall operation of the market and has important implications for linkages between the stock and index futures markets (see Chapter XIII below).

Regulations in overseas markets

5.3. In the US, short selling is permitted and has been regulated since 1934 by the Securities and Exchange Commission. Sales must be marked either long or short and a short sale is only allowed on an "up-tick" (where the price of the short sale is higher than that of the previous trade) or on a "zero-plus tick" (where the price of the short sale is equal to that of the previous trade which itself must have been higher than the price of the last trade at a different price). Moreover, it is prohibited to certain insiders and beneficial owners of large parcels of shares. In Japan, short selling is permitted under conditions identical to the US, the only exception being the "up-tick" rule where the Japanese prohibition is against short sales at a price lower than the last sale without a need for it to be higher and without reference to the price for preceding trades. In the UK, the previous jobbing system and the present market-maker system is predicated on the ability to sell short and there is no "up-tick" rule. In Canada, short selling is allowed along the lines of the Japanese system. In Australia, short selling is permitted under requirements modelled closely on the US system.

The local scene

5.4. In Hong Kong, Section 80(1) of the Securities Ordinance seeks to prevent short selling by making it an offence for someone to sell securities if he does not have "a presently exercisable and unconditional right to vest the securities in the purchaser". The penalty for the offence is a fine of \$10,000 and imprisonment for six months.

5.5. Despite Section 80, we understand that short selling is practised on a significant scale in Hong Kong. We were told that three forms are used :-

- (a) punters sell short in the early part of a trading day in anticipation of a falling market and cover their short sales towards the end of the day's trading;
- (b) large shareholders sell stock but choose to settle the trades by stock borrowing in order to preserve their holdings (mainly to avoid diluting their holdings in, and hence control over, the company); and
- (c) brokers sell stock and use stock held as security for margin loans to customers for delivery, replenishing the pool later.

5.6. While the former practice falls squarely within the ambit of Section 80, and is therefore illegal, it is extremely difficult to monitor or prevent. The main difficulty is that at the end of the trading day when deals are normally matched for settlement, the short seller comes up square. Unless an intra-day spot check is made into the details of his stock holdings, it would not be possible to establish whether he is in possession of the necessary stock for delivery. Moreover, no subsequent audit trail is available as he is not obliged to borrow stock to settle.

5.7. The second practice, on the other hand, arguably falls outside the ambit of Section 80 because the seller has an "unconditional right to vest the securities" in the buyer. The fact that he has no intention to settle the trade from his own holding is not a material fact under

Section 80. The transaction would appear therefore to be legal. Short of banning all stock borrowing (which has other legitimate uses), it would not be possible to prevent such an "abuse" from occurring.

5.8. The third practice, borrowing of margin stock by brokers may breach the short-selling rules but otherwise appears to be legal.

5.9. Many submissions called for the legalisation of short selling. The arguments in favour of allowing short selling included :-

- (a) it would add liquidity to the market, particularly in view of the large number of thinly traded stocks in Hong Kong and the small public holdings in a substantial number of the larger listed stocks. In fact, some international experts have remarked that they could not understand how any market could ensure liquidity without the ability to sell short (this is the basic rationale of the London market-making system);
- (b) it would help to smoothen sharp market declines; short sellers would buy stocks (and thereby support market prices) when they attempted to lock in their profits by covering their short positions in a falling market;
- (c) it would remove an existing inherent fault in the local futures index market, i.e. the lack of symmetry, and, by completing the arbitraging function between the cash

and futures markets, it would provide an incentive to trade futures in a bear market thus helping to revitalise the Hong Kong Futures Exchange (see Chapter VI);

- (d) it would provide a useful price stabilisation mechanism enabling the market to correct short-term price imbalances and help to prevent the over-valuation of individual stocks through manipulation;
- (e) it would enable proper disclosure, regulation and surveillance to be introduced in respect of an activity that already exists to a significant extent; this would ensure a more transparent and fair market; and
- (f) it would bring the Hong Kong market into step with other major financial markets.

5.10. The arguments advanced against legalising short selling included that :-

- (a) it is purely speculative and cannot be regarded as a form of investment. It should therefore not be condoned through legalisation;
- (b) in particular, the Hong Kong market is not mature enough to support such a highly speculative trading mechanism (which might be confirmed by the rise and fall of the stock index futures contract on the Hong Kong Futures Exchange);

- (c) it could de-stabilise the market and accelerate a market collapse;
- (d) given the nature of the Hong Kong market (i.e. the large number of thinly traded stocks and the small public holdings in a large number of the larger listed stocks) short sellers would facilitate the development of corners⁽¹⁾ which could lead to serious disruptions and abuses;
- (e) the existing settlement, disclosure, regulatory and surveillance systems in Hong Kong are inadequate to ensure that it is properly monitored and controlled; and
- (f) in any case there is no apparent lack of liquidity in Hong Kong compared with other major markets.

Recommendations

5.11. We are of the view that while the advantages of allowing short selling relate principally to its functional advantages and contribution to the effective operation of the market, the disadvantages relate mainly to the dangers posed by potential abuses. The answer is to take action to curb the abuses. Moreover, given that some forms of short selling are already practised here its legalisation would enable this to be better controlled. We therefore

(1) A "corner" arises when a buyer purchases more than the available supply of a security with the intention of forcing short sellers to settle on terms dictated by him.

recommend that, provided the necessary safeguards and regulations are introduced, short selling should be allowed in Hong Kong.

5.12. The measures to guard against the dangers inherent in short selling which might be introduced include :-

- (a) limitations on the stocks which might be sold short - only liquid stocks where a sizeable number of the shares are in public hands should be allowed to be sold short to avoid a false market and corners from developing. In this connection, since one of the strongest arguments in favour of allowing short selling is in relation to the index futures market, and since the components of the Hang Seng Index (HSI) represent the most liquid stocks in the local market, there is a case for limiting short selling, at least initially, to HSI component stocks;
- (b) limitations on who could sell short - as with the US and Japan, officers and insiders and beneficial owners of large parcels of shares could be prohibited from selling short. Apart from this, while it is probably undesirable to allow members of the general public to sell short, there does not need to be any specific ban on particular individuals or classes of individuals from selling short. A better safeguard is a network of "know your client" rules, clear client agreements, risk disclosure documents and tight margin

requirements (marked-to-market daily) to prevent the uninitiated and irresponsible from selling short;

- (c) limitations on the extent particular stocks could be sold short - Hong Kong could adopt the Canadian system of a series of thresholds for individual stocks beyond which specific restrictions on the ability to sell short would automatically come into operation;
- (d) limitations on when a permitted stock may be sold short - as with most of the other major markets, short selling could be allowed only on an "uptick", or a "zero-plus tick"⁽²⁾;
- (e) proper disclosure of short sales - as with the American system each trade could be marked either long or short and the client could disclose this to the broker before the trade is dealt on the Exchange;
- (f) proper and efficient monitoring of the activity - the exchange and the regulatory authority should monitor closely the activity and ensure transparency of operation through active dissemination of data to the market; and

(2) However, this may constrain arbitrage between the cash and stock index market if prices are falling. It is therefore reviewed in Chapter XIII below.

- (g) the total short position in the market for any particular share could be published regularly (say weekly) by the SEHK.

5.13. We believe, however, that there must be a doubt whether the SEHK and the regulatory authority have the necessary resources to develop and introduce such safeguards and regulations at the present time. We do not believe that legalisation of short selling is of such pressing importance to the local market that priority should be allocated to work on this area at the moment. We therefore further recommend that short selling should be deferred at least until the restructuring of the SEHK and the regulatory authority has been successfully completed, and the two bodies have developed sufficient resources and capability to monitor and control the activity.

LISTING OF SECURITIES ON THE EXCHANGE

Major complaints

5.14. The listing of securities on the Exchange generated a substantial amount of criticism in nearly all submissions to the Committee. Issuers and merchant bankers impressed upon us that listing was a major problem warranting urgent attention and we are convinced that it was one of the fundamental defects in the management arrangements formerly obtaining at the Exchange. In this section, we address the role and responsibilities of the Listing Department of the SEHK.

5.15. Among the major complaints of the SEHK's listing arrangements raised in submissions were : -

- (a) that the SEHK played an active role in pricing new issues. It was alleged to have insisted on issues being underpriced and with low minimum subscriptions;
- (b) that the one-issue-at-a-time queuing system lacked flexibility and failed to take account of market conditions; and
- (c) that re-activation of shell companies had become prevalent to avoid the listing rules.

5.16. Although there were complaints about the number of warrants flooding the market, we note with approval that the SEHK has recently taken steps to curb this practice. We ourselves observed that quotations on the SEHK were suspended frequently and for long periods. We deal with these in para. 5.28 below.

Role of the SEHK Listing Department

5.17. The regulation of new issues and listed companies is essential to ensure the integrity of the market. The authorities should have the following objectives : -

- (a) that the issue of securities is fair and orderly for the benefit of issuers and investors alike;
- (b) that shareholders are fully informed of significant developments affecting the value of their company; and
- (c) that all shareholders are treated equally.

5.18. At the moment, responsibility for achieving these objectives are split haphazardly among the Exchange, the Securities Commission, the Office of the Commissioner for Securities and the Registrar General. In Chapter XI below, we discuss the statutory requirements for marketing new issues and, amongst a number of measures designed to simplify procedures, we propose that the SEHK Listing Department should have sole responsibility for vetting listing prospectuses. The Exchange's role should be to lay down listing requirements and ensure that these are being complied with by companies seeking listing.

5.19. However, as we point out in Chapter XI below such responsibilities should only be vested in the Exchange provided it is able to discharge those responsibilities impartially and effectively.

5.20. The SEHK management recently recognised similar concerns and engaged experts from the Quotations Department of the International Stock Exchange(ISE), London, to review the procedures and organisation of the Listing Department. Their report, submitted to the SEHK in March 1988, highlighted three main deficiencies. First, the listing rules themselves, apart from being over-complex, are in need of general enhancement to reflect current practice. We consider this further in Chapter XI below.

5.21. Second, the Listing Department has not acted as the principal focus for the release of price sensitive company information. As the report says,

"It is essential to the maintenance of public confidence in the market place that board deliberations are made in the strictest confidence. Only when a decision has been reached should third

parties, other than the company's main advisers, be informed. Once communication is to be made the news must be made available as quickly as possible to the widest spectrum of the public. This will entail the establishment of a central focus for collation and dissemination of news to the market to enable the price of a security to reflect the latest information thus putting both parties to a transaction in the security in possession of the same knowledge."

In our view, this entails improvements to the Exchange's information system so as to ensure that more information can reach more people more quickly.

5.22. Third, the Listing Committee should delegate more to the staff who should be principally involved in dealing with listing matters. The Listing Committee itself should rarely be involved in deciding individual listing questions⁽³⁾.

5.23. We welcome the measures which are currently under way to re-organise, upgrade and strengthen the Listing Department. These include a move to new accommodation in a separate building and recruitment of professional staff. We urge the Exchange to continue to strengthen the Listing Department and implement as soon as possible the recommendations of the London team. We recommend that, within 12 months of our report being published, the regulatory authority should review the steps taken to strengthen the Listing Department of the SEHK.

(3) Details of the report are contained in Appendix 18.

Pricing of new issues

5.24. It is clear that, in the past, the Listing Committee of the SEHK played too active a part in pricing new issues and organising a queue of listing applicants. The first measure, by depressing prices, ensured that new issues went to a substantial premium and that vendors received less than that company was worth. In addition, if new shares are issued, under-pricing can increase the cost of raising capital, sometimes well beyond what a company could achieve through bank finance or by listing on an overseas market. In short, systematic under-pricing acts as a disincentive to companies meeting their capital needs via the Hong Kong equity markets.

5.25. We strongly believe that the price at which a new issue is brought to the market is fundamentally a market judgment and should therefore be left to the issuers or vendors and their professional advisers - especially the brokers, merchant bankers and underwriters to the issue. We recommend that the pricing of new issues should be left entirely to companies, their advisers and underwriters; the SEHK should play no part.

The new issue queue

5.26. The new issue queue has had the effect of rationing access to the market. This may increase the cost of capital if a company misses an attractive opportunity. We believe that it is unnecessary for the SEHK to organise a queue of new listings. We have been assured by the Monetary Affairs Branch that new issues do not generally create any serious money market problems, cash requirements are not large enough. Market forces will ensure that those handling new issues will make their own arrangements to

ensure that competing issues do not clash. We therefore recommend that the SEHK and the regulatory authority should review the new issue queuing system.

Shell companies and acquisitions

5.27. In recent years, companies seeking a listing have adopted the stratagem of buying a company which already has a listing and which has ceased active business. We have seen cases where those involved have stated openly that this was to avoid the full rigour of listing procedures which have been established to protect the investing public by ensuring that full details of the proposed investment are published before the investment is made. The device of using shell companies in this way is unacceptable. We therefore recommend that the listing of any company which ceases to trade should be cancelled, and if such a company is acquired by a purchaser and a major change of business is intended, full listing requirements should be imposed.

Suspension

5.28. In the two years since the Exchanges were unified there have been 231 occasions when trading in a share was suspended at the request of the company concerned : in 71 cases, trading recommenced the next day, in 106 cases, within a week and in 54 cases, the shares were suspended for a longer period of time. In eight cases, the shares are still suspended. In another five cases, trading was suspended at the request of the authorities⁽⁴⁾. Companies usually request suspensions pending release of

(4) See Appendix 19 for details. With ten times the number of companies the London Exchange had about the same number of suspensions for the two years from March 1986 - March 1988.

price sensitive information about the company. While shares are suspended, investors are deprived of the right to sell their shares except at a discount in the grey market. The correct procedure should be for the company to submit the price sensitive information at once to the SEHK who should immediately release it on the dealing screens. Ideally, shares should not be suspended at all. In any case, so many lengthy suspensions are a sign of laxity. We recommend that the SEHK should review its procedures on suspension with a view to increasing the promptness with which price sensitive information is made available.

Sponsoring broker

5.29. We believe it is important that, so far as possible, the Exchange should directly enforce the requirements imposed on listed companies by dealing with the company boards and directors concerned. However, the SEHK has suggested that much could be achieved in this area by developing the role of sponsoring brokers.

5.30. Under the present Exchange practice, the requirement for a sponsoring broker is merely a formality, he plays no part in ensuring the quality of the application and has no role to play after the company is listed. The Exchange believes that the sponsor's role should continue beyond the initial listing of securities and that he should act as a conduit between the company and the SEHK, and help to ensure that the company complies with the listing requirements on a continuous basis. Because many brokers probably do not have the resources to act in this capacity and because brokers are peripheral to many issues, the Exchange has also floated the possibility of merchant bank issuing houses acting as de facto sponsoring brokers.

5.31. We believe that, if they could be developed, sponsoring broker arrangements would help to ensure listed companies comply with market rules, particularly regarding the timing and extent of disclosures. However, because the idea is unfamiliar and because companies frequently change their advisers, we are doubtful whether they could substitute for direct enforcement against listed company boards.

Industry bodies

5.32. To ensure that the Hong Kong stock market does not lag behind other major markets in new issues techniques and to provide the necessary market input and expertise, we believe that the formation of industry bodies, representing issuing houses and institutional investors, should be encouraged.

DEALING SYSTEM OF THE EXCHANGE

Present situation

5.33. In Hong Kong, exchange dealers perform as dual capacity broker-dealers. There are no market-makers⁽⁵⁾. Trading on the SEHK is continuous (apart from a lunchtime break) and order-based via a computer-assisted trading system. Buy and sell orders are

(5) A market-maker system involves designated intermediaries who are obliged to buy or sell a specific stock at all times quoting firm two way prices. This system is used in the London Exchange's electronic-automated quotation system (known as SEAQ) and in the US over-the-counter market, the National Association of Securities Dealers Automated Quotation System (NASDAQ).

input into the computer and shown on the screen; deals are generally struck by telephone. However, broker-dealers continue to operate from the floor of the Exchange and trading is therefore occasionally face-to-face.

5.34. The submissions contained few criticisms of the dealing system. Many applauded its success and its efficient operation which has facilitated large trading volumes on the Exchange.

5.35. However, some concerns have been raised which we should record. Most notably that, with the increasing participation of major brokerage houses, some large trades are originated outside the Exchange, although they are usually crossed on the floor. While this is not undesirable in itself, it is important that, if Hong Kong develops a so-called upstairs market, the price determination role of the trading floor should not be reduced.

Market-making system

5.36. Some submissions argued that it would be desirable to introduce market-making. With a market-maker system, competitive market-makers arguably help to improve liquidity. The introduction of such a system would, however, raise a number of significant operational issues for the SEHK including which stocks should go on a market-maker system, who should be market-makers, what should be their rights and obligations and how should they be capitalised and supervised to ensure proper risk management.

5.37. We believe that there is no pressing need for a market-maker system in Hong Kong for the following reasons : -

- (a) there is no evidence that the existing order-based system failed in the events of October 1987;
- (b) the costs to the SEHK and members of establishing a market-maker system might be considerable; limited resources would be better used in improving the settlement system;
- (c) only heavily capitalised dealers could take on the risks of acting as market-makers, which might result in a handful of international securities houses monopolising the system;
- (d) the need to deal through market-makers might reduce brokers' profit margins and could undermine small local brokers' independence;
- (e) it might be difficult to find firms prepared to make continuous markets in Hong Kong's illiquid stocks, particularly in bull or bear markets, as the potential cost could be high; and
- (f) it would be unlikely to improve the liquidity in fundamentally illiquid stocks; a dealing system cannot of itself create interest in a stock.

5.38. Accordingly, we recommend that Hong Kong should not move to a market-maker system but should continue with the existing order-based system.

Overseas market-making and stamp duty

5.39. We are, however, aware that at least eight international broking firms make a market in up to 15 leading Hong Kong stocks in London.

5.40. The market in London emerged from the rapid growth of international institutional investment in Hong Kong stocks. At times these institutions like to control their positions on a 24-hour basis and to deal within their own time zone. Most of the business is conducted on an agency basis, with London firms going direct to the Hong Kong market via local brokers or their own local offices. However, we were advised by the ISE that about 10% of the business in London is handled by market-makers. According to the information supplied by London, the value of business brought into Hong Kong by London market-makers for the period August 1987 to January 1988 was \$5.74 billion against a turnover of \$85.6 billion for the same stocks on the SEHK during the same period.

5.41. It has been represented to us that the current liability of overseas transactions to stamp duty under the Hong Kong Stamp Duty Ordinance and the absence of relief provisions for transactions by market-makers is an impediment to the development of a competitive market-making system for Hong Kong stocks in London (and elsewhere).

5.42. It is further argued that if Hong Kong wishes to enhance its position as an international market it should come into line with international practices. For example, sales of Japanese stocks outside Japan are exempt from the 0.55% sales tax. Likewise, no stamp is payable on transactions in Australian stocks outside Australia between

market-makers as it is a "registration stamp" and not a transaction tax. The US has no transaction tax and in Singapore, tax is limited to 0.3% on registration. The Inland Revenue in the UK charges only a nominal stamp on transactions by market-makers and exempts them from Stamp Duty Reserve Tax (which is a tax on transactions rather than the change of beneficial ownership).

5.43. As a matter of principle, we believe that overseas transactions involving a local element should not be treated more favourably than local transactions. Apart from broad considerations of equity, concessionary treatment for such overseas transactions could lead to a significant proportion of the market moving offshore purely to avoid stamp duty, particularly as a number of the largest local brokers have good connections overseas and could easily arrange for their transactions to be crossed offshore.

5.44. We believe, however, that the existence of a competitive market-making system for Hong Kong stocks overseas improves international visibility and liquidity for Hong Kong stocks and the Hong Kong market generally. We therefore recommend that overseas market-makers should be given some relief from stamp duty to enable them to discharge their functions efficiently. This could be achieved by the introduction of subsidiary legislation under the Stamp Duty Ordinance, which already contains a provision for stamp duty relief for "jobbing

(6)
business" .

5.45. Conditions would, in our view, have to be applied to ensure the exemption was not abused. We recommend that such exempted market-makers should be approved by their own exchanges, (e.g. registered with the ISE), and recognised by the Inland Revenue authorities in Hong Kong. In return for such privileges, they should be obliged to discharge the full range of duties of a market-maker in respect of the Hong Kong stocks, that is, they should be obliged to quote definite two-way prices for the Hong Kong stocks at all times⁽⁷⁾. We recommend that the concession should only apply to authorised market-makers. Clients with whom the market-maker trades should continue to be liable to stamp duty. Although we see no present need for a market-maker system in Hong Kong, we believe that if Hong Kong develops such a system in future, the same concessions should extend to local market-makers.

5.46. In summary, we recommend that the concessionary stamp duty rate currently available to jobbers under the

(6) Head 2(2) of the First Schedule to the Stamp Duty Ordinance specifies that a contract note in respect of jobbing business is only subject to a nominal stamp of \$5. "Jobbing business" is defined as any business carried on by a broker which is specified as jobbing business by regulations made under S. 63. To date, no such regulations have been made and the concessionary treatment envisaged in law has never been operative. These provisions were no doubt introduced when the jobbing system obtained in London. As the jobbing system has been replaced by the market-maker system, it would be logical to extend, and activate the concession to market-makers.

(7) At present, market-makers registered with the ISE are not obliged to make a market at all times.

stamp Duty Ordinance should be extended to authorised market-makers of Hong Kong stocks and legislation should be introduced to bring the concession into force.

SETTLEMENT

Background

5.47. One of the most controversial subjects that we have had to deal with is the settlement system of the SEHK, the third element in SEHK operations. Apart from being the reason the SEHK gave for closing the stock market during the October crash, the majority of submissions commented on the subject.

5.48. The concern with settlement issues is shared overseas. Indeed, the main issues were described in a paper to a Group of Thirty⁽⁸⁾ Symposium held in London on 9 March 1988,

"An efficient clearance and settlement process ... serves the public purpose by reducing the cost of capital to market participants, by minimising the possibility of credit and counterparty failures that could extend to the banking system and by reducing systemic risk Unless more attention is given to the mechanics of settling transactions, the market will not develop efficiently and may be severely constrained by volume"

(8) The Group of Thirty is a body of thirty individuals from four groups: international banks, international businessmen, academics and officials past and present. It is chaired by Lord Richardson, a former Governor of the Bank of England.

5.49. The money side of the settlement process also raises fundamental issues, given the risks involved in payments systems. As the President of the Federal Reserve Bank of New York put it graphically in January 1987,

"These large-dollar payments systems link together all major institutions on a world-wide basis - but especially the large banks and large securities houses - in ways that create operational, liquidity and credit interdependencies that stagger the imagination⁽⁹⁾."

5.50. Thus, settlement is not just about back-office processing; and improving the Hong Kong system is not merely a matter of convenience. The main issues are about risk and systemic stability.

5.51. In view of the importance of this issue, we begin by setting out what is involved in the settlement of equity transactions and describing the present system in Hong Kong.

5.52. Settlement is a step-by-step process, involving agreeing trades, calculating the securities and cash due, settling money against securities, transferring legal ownership and entering changes on a register. The steps involved are : -

(a) comparison (or matching). This is the verification and confirmation of the terms of a deal, through comparison of the

(9) Financial Market Structure: A Longer View, E. Gerald Corrigan, President of Federal Reserve Bank of New York, January 1987.

buyer's and the seller's records. Matching may be undertaken bilaterally or by a central agency;

(b) clearing (or accounting). This is the process of determining who owes what to whom prior to settlement. It may be done on a contract-by-contract basis; or by netting daily balances; or by continuous net settlement (CNS) where any unsettled amounts are carried forward to the next day;

(c) settlement. This is payment and delivery. Settlement periods vary considerably, from 24 hours in Hong Kong; through five-day rolling settlement on the New York Stock Exchange; to ten days after the previous two-week trading account in London. Delivery may be physical as in Hong Kong, or by book entry where there is a central system : the book entry increases the buyer's securities balance and reduces the seller's securities balance with equal and opposite money movements; and

(d) transfer and registration. Sales will usually be settled before the underlying transfer of ownership is recorded on the main register of the company and a new certificate is issued to the buyer.

5.53. The Hong Kong system is based entirely on physical settlement of individual trades. No part of the process is

centralised or automated and there is no netting of trades between brokers before settlement. Each deal must be settled by 3.45 p.m. on the day after the trade by the physical delivery of a certificate and a stamped transfer form against a cheque which can in many cases only be cleared a few days later. In order to ease resale, the certificates must be in board lots with individually stamped transfer forms attached(10).

5.54. If a buyer wishes to exercise shareholders rights, transfers must be registered. Under SEHK rules, registrars have 21 days to register transfers and issue new stock certificates. Shares cannot be sold pending registration because of the 24-hour settlement rule, the prohibition on short selling and the lack of any alternative arrangements such as stock lending. For this reason, many shares are held in street names(11) and therefore effectively in bearer form with registration work being concentrated before dividend or rights record dates. In addition, many institutional investors (including overseas investors) hold their scrip in the vaults of banks and custodial agents, which means that separate delivery instructions have to be issued to the custodian before the scrip can be delivered.

Weaknesses in the current system

5.55. Briefly, the following complaints have been made against the existing system :-

(10) Board lots are standard parcels of 100 - 5,000 shares depending on the company. Trades must be in board lots unless the parties agree otherwise.

(11) Street Names. Shares intended for sale are endorsed in blank and accompanied by a signed transfer form. They may then be sold and re-sold so that the name on the certificate - the street name - is not that of the beneficial owner who is selling.

- (a) intolerable settlement delays occur⁽¹²⁾, both broker-broker and broker-client. This was particularly acute during the summer and autumn of last year when volumes increased significantly;
- (b) unreasonable demands have had to be made on back-office staff, which gives rise to operational risks;
- (c) scrip-against-cheque delivery leaves the seller with counterparty exposure until the cheque is cleared;
- (d) shares cannot be sold while a buyer awaits registration, giving rise to a serious market exposure (and thus deterring registration);
- (e) brokers run considerable security risks by carrying scrip in street names around Hong Kong;
- (f) a broker has to finance a deal and take the counterparty risk if he has taken delivery of scrip but awaits release of funds from overseas buyers. He is unable to hedge the risk as he does not have title to the scrip and therefore cannot pledge it to a bank lender; and
- (g) in the absence of stock lending there is no way in which a large order can be

(12) The backlog can of course become a vicious circle, with brokers unable to deliver because they are themselves awaiting a delayed delivery.

settled if part of the scrip is still outstanding.

5.56. These problems are, in our view, serious because we feel that investors and intermediaries should be sure that they can settle their trades promptly and, at the least, within the prescribed time. Moreover, the backlog aside, the present method of settlement has too many inherent risks. Finally, there are considerable systemic dangers in a settlement system which cannot cope with large volumes.

5.57. We believe the problems arise because of the following weaknesses in the current system :-

(a) **short settlement period.** Twenty-four hour settlement was feasible only when trading volumes were much lower and investors were almost exclusively domestic. However, with growing international interest and increased volumes, it is physically impossible to settle within 24-hours, particularly where the seller is an overseas institution as instructions have to be given in another time zone and scrip has to be released by custodians. Some local brokers dealing only on behalf of local investors are also unable to comply with the rule;

(b) **physical settlement.** This increases the work and the risks involved as deals are settled trade-by-trade and face to face;

(c) **board lots.** The board lot system exacerbates the problem of physical

settlement as it increases significantly the amount of paperwork involved for all concerned; and

(d) lack of stock borrowing. Until July 1987, stock borrowing had helped to cope with the backlog. Recent action by the stamp duty office is said to have effectively closed off this route because the costs are now prohibitive.

5.58. Generally speaking, the problems can be put down to the inability of brokers, registrars and custodian banks⁽¹³⁾ to cope under a physical system with the significant increases in trading volumes experienced in the local stock market during the past two years. It is salient to point out that the volume of trades needing settlement increased eight times⁽¹⁴⁾, but settlement staff only doubled.

5.59. In this climate, the greatest difficulty has been caused by the uncertainty and lack of discipline in the present system. The 24-hour settlement system has broken down, with brokers willing to give their counterparties time to complete. We regard the introduction of discipline into the SEHK settlement arrangements as a first priority. To do this major changes are needed.

5.60. The problems can, broadly be divided into four related issues: the settlement procedure; the settlement

(13) In responding to a recent SEHK questionnaire, brokers blamed 50% of the backlog on the custodian banks.

(14) The average number of shares traded per day increased from 101 million in April 1986 (when the Unified Exchange opened) to 843 million for the period August - October 1987.

period; stamp duty on stock borrowing for settlement purposes; and the registration system. In the following paragraphs, we deal with each of these issues in turn, examining what improvements might be made to improve the efficiency and security of the current system. We then address the possibility of developing a paperless, centralised clearing, settlement and registration system.

Settlement procedure

5.61. We are convinced that the present procedure, involving small board lots with individual transfer forms each of which have to be signed and stamped (twice); the absence of centralised matching; the need for physical delivery to different brokers and the length of time required for registration (exacerbated by frequent lengthy delays) during which the shares cannot in effect be traded, is totally inefficient and creates unacceptable risks to the parties involved. It must be improved. We believe that the majority of the problems can be effectively addressed with the introduction of a central clearing and settlement system. We note, however, that the development of such a system is only in its preliminary stages and is unlikely to be in place for another two years at the least. We therefore urge the SEHK and the regulatory authority to work together to introduce some interim measures to mitigate the problems identified.

5.62. For reference purposes, we list in Appendix 20 possible interim measures which have been suggested in submissions and during our discussions with interested parties.

Settlement period

5.63. The existing 24-hour settlement rule⁽¹⁵⁾ was introduced many years ago at a time when interest in the Hong Kong stock market was essentially domestic and trading volumes were much lower. With increasing international participation and higher volumes, it has been difficult, if not impossible, for both international and purely local trades to comply with the rule. The rule has therefore been generally ignored.

5.64. Local brokers argue, however, that if steps could be taken to reduce the volume of paper work in the system, it should be possible for the 24-hour settlement rule to be enforced. They are concerned that any extension of the settlement period would entail a significant increase in their financial resources to cover increased exposure to counterparty risks and reduced liquidity, and that it would therefore render the Hong Kong market less efficient. The smaller brokers are also concerned that extending the settlement period would make it more difficult for them to collect payments if the price moved against them. (They also argue that it would provide a loophole for illegal short selling, although in our view this is only an issue if the ban on short selling continues.

5.65. Brokers acting for international clients, on the other hand, argue that retention and enforcement of the 24-hour settlement rule would drive international investors out of the market because of their inability to settle in time. They argue that if Hong Kong wishes to develop into

(15) The so-called 24-hour settlement rule is actually a misnomer in that settlement is not required to be effected within 24 hours. It is actually "next day" settlement, or, in overseas settlement parlance, settlement day is "Trade day plus 1" (T+1).

an international market - or, at the very least, continue to cater for international investors - the deadline must be extended.

Advantages and disadvantages of the existing rule

5.66. In principle, equity markets should have short settlement periods as buyers should be able to take delivery of what they have bought quickly, as with any other commodity. The main attractions of a 24-hour settlement rule are that, if followed, it reduces counterparty risks to a minimum, enhances liquidity and is efficient. The problem is, of course, that it is currently honoured only in the breach. We believe that a rule which is not enforced or obeyed should either be rescinded or amended. Any large scale breaches of the rule or even tolerated exceptions are undesirable as they cast doubt on the integrity of the entire body of exchange and market rules.

5.67. Moreover, non-enforcement of the 24-hour settlement rule creates substantial risks to the players in the market. This is because they cannot be sure whether an unsettled trade is merely delayed or whether the counterparty is in default. It also puts great strain on brokers' capital and liquidity in respect of orders which involve collating a number of smaller trades from different brokers. If one of them fails to deliver or delays settlement, the buying broker cannot get payment from his client because he is, as yet, unable to settle the entire order. In consequence, he has to finance the holding of the delivered portion out of his own resources. In other words, the advantages of a 24-hour settlement rule do not always accrue at present to the brokers.

Case for amending the rule

5.68. We believe the prime consideration should be the ambitions of the Hong Kong market. As stated in Chapter III, it is fundamental to our approach that Hong Kong must cater for international investors. In our view it must therefore move towards international settlement norms and change the existing 24-hour settlement rule.

Optimum settlement period

5.69. In deciding the optimum period, it is essential to balance the genuine and legitimate concerns and needs of both local brokers and international investors. As a matter of principle, we believe the settlement period should be as short as is consistent with international practices when efficiently executed.

5.70. We therefore start by examining the practical situation of the overseas investor, particularly the institutional client.

5.71. In normal circumstances, a typical settlement involving a foreign institutional investor is as follows :-

Trading Day Broker executes order and sends reporting telex to overseas client.

Day T+1 (a) The broker's overseas client (typically an investment manager investing a third party's funds) receives reporting telex and advises his client (typically the trustee of a fund).

(b) Trust company receives advice.

Day T+2 (a) Trust company sends settlement instructions.

(b) Hong Kong custodian agent receives settlement instructions, contacts broker and prepares scrip.

Day T+3 Delivery and settlement.

5.72. But the foregoing example is simplified. If the fund manager, trustee, custodian and sub-custodian are in different time zones and some are in tax havens more than three days may be required without allowing time for possible errors. Because of the time taken to process instructions, pass internal memos from one department to another and prepare further instructions to outside parties, it is not appropriate to assume instantaneous action at each stage of the process. The separation of functions between fund manager (i.e. the client), trustees of the fund (i.e. the trust company) and custodians are not business practices which can be amended to cater for the 24-hour rule in Hong Kong; they are usually based on legal requirements imposed by the laws of certain countries to prevent abuses of power and protect investors.

5.73. Some of the international brokers have argued, in particular, that an extension to T+3 is insufficient given cases where the overseas client, the trust company and the custodian are each in different time zones. They also felt that it is reasonable to provide some leeway for cases requiring verification of details or for errors and omissions. They have, therefore, strongly advocated a T+5 system.

5.74. While we are sympathetic to the arguments advanced by the international brokers, we believe that Hong Kong should opt for the minimum period necessary to settle most trades. We therefore recommend that Hong Kong should adopt a T+3 system(16).

5.75. The main advantages of a T+3 system is that it should be short enough to safeguard the interests of local brokers but is nevertheless long enough to satisfy most overseas investors.

5.76. Extending the settlement period inevitably means increasing a broker's risk in respect of his counterparties, i.e. the other broker and his client. In order to help local brokers adjust to the change, we believe that there should be a central guarantee of each trade on T+1 or as soon thereafter as the trade is matched and confirmed(17). The broker would not then be exposed to any more risk with regard to the broker counterparty than he is at present under the 24-hour settlement. We accept that the system increases a broker's risk exposure to his client who may be disinclined to honor the trade if prices move unfavourably. We believe that such risks are best covered by closer knowledge by the broker of the client and more stringent house requirements, such as deposits, before dealing with risky clients.

(16) The settlement periods in the major markets are: New York - T+5; Tokyo - T+3; London - account system; Singapore T+5; and Australia - moving towards T+5.

(17) We develop this point below when considering central clearing. Until central clearing is introduced, the guarantee could be provided by the SEHK and backed by the Fidelity Fund. It would obviously be impossible to introduce a SEHK guarantee until a central trade matching facility is in place.

5.77. It should be possible to avoid increasing brokers' capital requirements by requiring settlement to be on a rolling basis. With a rolling settlement period, each day's trades are settled four days later. A broker would therefore only be required to settle one day's trades at a time.

5.78. To sum up, we recommend that the settlement period should be a rolling T+3. Thereafter, there should be strict enforcement by the SEHK. We further recommend that the new settlement period should be introduced as soon as a central guarantee of trades can be put in place.

Stock borrowing

5.79. The borrowing and lending of scrip is a common means adopted by stockbrokers to expedite the settlement of transactions under the 24-hour settlement rule. A broker who is temporarily short of scrip borrows from another broker to meet his delivery obligations.

5.80. A stocklender will provide the required shares usually on an exchange of letters and the receipt of a cash deposit equal to the prevailing market price of the shares loaned plus a 20% to 30% margin. In addition, the lender has the right to call for additional margin money where the market value of the loaned stock has increased. The borrower will then be able to complete his transaction while the lender will have the temporary use of the funds. Later, when the borrower receives the scrip, he will return the shares to the lender and the deposit will be refunded.

5.81. Stock lending is, however, a risky business because the lender is exposed to both position and credit

risk. He has position risk exposures from changes in the market price during the period the stock is on loan and he is unable to sell it; he has credit risk exposure because of the possibility of default by the borrower. For these reasons, stock lending is strictly controlled in nearly every major market and is usually restricted to particular classes of lenders or intermediaries e.g. the money brokers in the UK and the central clearing agencies in other major markets. At the moment, no such controls exist in Hong Kong.

5.82. Nevertheless, we were told that the local market relied heavily on stock lending during the bull run in 1986/87. It was put to us that, had it not been for the availability of stock borrowing, Hong Kong would have faced even more serious settlement delays during this period which could have disrupted the market.

5.83. In July 1987, the Commissioner for Inland Revenue wrote to members of the SEHK reminding them that, in his view, stock lending and borrowing lay within the scope of the Stamp Duty Ordinance. As a result, enforcement of the duty of 0.3% on both parties on lending the stock and a similar duty upon return of the loaned stock was generally tightened, making stock lending for settlement purposes unduly costly. It is possible that this contributed to the severe settlement backlog which occurred immediately prior to the October crash.

5.84. The SEHK is strongly of the view that charging stamp duty on stock lending and borrowing reduces its usefulness for relieving settlement difficulties. We are sympathetic to the request for stamp duty concessions for stock lending/borrowing as it is a well-tried and internationally used method to resolve temporary settlement

problems. Moreover, under a 24-hour settlement system, the availability of stock lending appears to be vital to avoid settlement backlogs.

5.85. We should add that even if the settlement period is extended to T+3, the need for brokers to borrow scrip to settle would not be completely removed. There will still be the odd occasion when clients would have to borrow scrip to settle. There will, therefore, be a continuing need for stock lending⁽¹⁸⁾. Furthermore, when the central clearing system is in place, the clearing house will have the ability to organise and control stock lending to facilitate the settlement system. Since the total cost of 1.2% duty, plus any charges levied by the lending broker, is heavy, stamp duty relief will be necessary to make stock lending a cost effective means to meet settlement requirements.

5.86. We therefore recommend that there should be stamp duty concessions for stock lending where the facility is used to resolve legitimate settlement problems. We understand that the SEHK has had discussions with the Commissioner for Securities on this issue and that the latter is sympathetic provided he can be satisfied with the safeguards to prevent abuses. We suggest that the regulatory authority discuss with the Commissioner for Inland Revenue what safeguards should be introduced to avoid abuse of any concession and to ensure that the risks are properly monitored and covered by capital adequacy requirements.

5.87. Irrespective of the question of stamp duty concessions, we believe that the SEHK should as a matter of urgency introduce rules to ensure that stock lending is

(18) See also para. 5.2 above on short selling.

properly controlled and monitored and that those who are allowed to lend stock have the ability to manage their risks properly.

Registration

5.88. Under SEHK rules, registration of share transfers must be completed within 21 days. Regrettably, in practice this has become the minimum period required for share transfers to be completed. We have received complaints that lengthy delays of up to eight weeks have been experienced. During this period, the shares are effectively locked in because of the prohibition against short selling and because of the lack of alternative means to allow the shares to be traded. This exposes investors to unnecessary risks if the market moves sharply during registration.

5.89. We have been advised that three weeks is required to complete transfers because of the lack of in-house computing facilities at the share registrars⁽¹⁹⁾. As a result, the work has to be contracted out and, in order to save costs, a weekly batch-processing method is invariably adopted. Transfer applications received during a week are held over to be sent by batch to the computer bureau for processing. The results are then verified the following week. In case of errors or omissions, they are returned to the computer bureau with the following week's batch for

(19) Few companies in Hong Kong undertake registration in-house and although there are some 38 registrars, one company, Central Registration Hong Kong Ltd., undertakes 70% of the work.

correction. Only after this procedure has been completed are new share certificates issued.

5.90. We believe that, in order to minimise the risk exposures of the investor, it is desirable to reduce the time required to complete share transfers even if this means increased charges. We suspect, however, that it would require time for the existing registrars to put the systems in place. We therefore believe that some interim measures would be required to enable shares pending registration to be traded. One possible solution that has been suggested to us is the use of a certified transfer system to prove that the shares are under transfer. Pending completion of registration, the transfer certificate could be used as valid title to enable the investor to continue trading the shares.

5.91. We therefore recommend that the maximum period for completion of share transfers should be reduced from the current 21 days initially to 14 days and eventually to seven days before the introduction of central clearing, discussed below.

5.92. In order to ensure that the existing lengthy delays do not recur and that the new requirements are respected, we further recommend that share registrars should be licensed by the regulatory authority and that registrars in frequent breach of their obligations should be deprived of the right to act as registrars for listed companies.

5.93. Finally, we recommend that the SEHK should examine in conjunction with the registrars possible measures, including the use of certified transfer certificates, to enable shares in registration to be traded.

Central clearing and settlement

Need for central clearing

5.94. Adjusting the current settlement arrangements, extending the settlement period, facilitating stock lending and expediting share registration are all palliatives. We believe that fundamental improvements in the settlement arrangements in Hong Kong depend upon moving away from a paper-based face-to-face settlement system towards a paperless, computerised system.

5.95. Central clearing involves a central clearing house calculating the payment and delivery obligations of its members, and issuing instructions accordingly. Brokers' obligations (cash and securities) are netted broker-to-broker or, more ambitiously, broker-to-market, so that trades are not settled individually. Cash and securities payments and deliveries are typically made via the clearing house rather than directly with other brokers; and often this is on a principal-to-principal basis because the clearing house has substituted itself as counterparty and, as such, guarantees trades.

5.96. The introduction of central clearing does not of itself directly affect the method of securities settlement and cash payment; it would be possible for physical delivery of scrip to continue. An efficient system therefore also encompasses centralised and computerised arrangements for holding and transferring shares by book-entry (and, where the clearing house is a counterparty, banking arrangements whereby cash payments pass through the accounts of the clearing house).

5.97. In addition to securing essential improvements in the settlement of broker-broker trades, however, the system

must also embrace broker-client trades. If these continue to be settled physically a backlog can emerge, significantly reducing the benefits of centralised settlement between brokers. This problem can be tackled in two ways. First, large institutional investors and nominee companies can participate in the system, holding accounts directly; by doing so they ensure that they continue to appear on shareholder registers (see below). Second, small retail clients can be brought into the system through holding their shares with participating banks and brokers.

5.98. The operational and financial benefits of a central clearing and settlement system can therefore be overwhelming. Through netting, it would reduce the flow of cash and paper between intermediaries. It can significantly reduce broker-broker counterparty exposures. It can expedite and increase the security of the settlement system by eliminating the use of transfer forms and it can significantly improve broker-client settlement. In short, it could be safer, quicker and easier.

5.99. We therefore recommend that Hong Kong should take active steps to develop a central clearing and settlement system.

5.100. Although the SEHK and the major banks have already instigated a review of central clearing we have considered the design of the system because it raises important questions of principle and regulatory policy. First, it affects shareholder rights and the transparency of company ownership. Secondly, we believe the clearing house will have an essential role to play in guaranteeing trades, managing the risks in the system as a whole and the day-to-day (and intra-day) monitoring of brokers' financial soundness. Third, as noted earlier in the chapter, smooth links with the payments system are also critical.

5.101. Against this background, we believe that, whatever system is developed, it should satisfy the following general requirements : -

- (a) all broker-broker trades should be cleared and settled in the system;
- (b) so far as possible, broker-client trades should be cleared and settled in the system;
- (c) shareholders should retain the option of holding share certificates physically;
- (d) the system should not impair relationships between companies and their shareholders and, in particular, should so far as possible avoid a significant decrease in the number of direct shareholders;
- (e) any risks assumed by the central agency must be prudently monitored, controlled and backed by adequate resources; and
- (f) the system should be professionally managed in the interests of the market as a whole.

5.102. We therefore examine, in turn, how shares should be held in the system, the clearing house's risks and the ownership, management and control of the system.

How shares should be held

5.103. There are two basic models for achieving book-entry transfer and settlement : -

(a) a depository company. The depository maintains all details of its members' shareholdings in computer form and transfers are effected directly in the depository's records. This is used by the New York Depository Trust Company (NYDTC) and Euroclear which clears and settles Eurobond trades; or

(b) an uncertificated system. This involves transfers in the clearing house's records becoming valid transfers in law by removing the need for share ownership to be evidenced by a certificate. The registrar's records are updated on a regular basis from the clearing house's records. This is the route typically adopted in European equity markets(20).

5.104. A depository system immobilises scrip. At its simplest, the depository is a super-custodian in that it centralises the holding and handling of securities certificates. The deposited certificates are held in fungible form, i.e. a holder cannot identify certain certificates as "his", rather he has an appropriate proportional share in the whole lot. In practice, the holding of certificates does not need to be centralised. Rather than having an enormous central vault, like the NYDTC, the scrip can be held by custodian banks acting on behalf of the depository, like Euroclear. Nor does a depository system in fact need to retain individual certificates; transfers can be made under a jumbo certificate held by the depository.

(20) For example, France, Germany, the London gilts market and, in due course, the London equity market. It is also the system currently planned in Australia.

5.105. A depository corporation is also a super-nominee since all the shares in the system are legally held in its name. The system can be looked at as a pyramid of accounts. Shareholders hold accounts with nominee companies; the nominee companies in turn hold accounts with the depository corporation, which is itself the shareholder of record. It receives and distributes to its account holders all company notices, dividends etc.

5.106. A depository acts as a clearing house for broker-client settlement in respect of clients, such as bank nominee companies or major institutions, who are members. In addition, depositories generally operate stock lending facilities.

5.107. The principal advantages of a depository system for Hong Kong would be that it could be built upon the existing custodial role of banks; i.e. scrip would be held in bank vaults. Some of the technology might therefore already be available in Hong Kong. Moreover, if a significant number of shareholders continue to hold physical certificates, it is a convenient means of enabling withdrawals from and deposits into the system as a shareholder can deal directly with his bank.

5.108. There are a number of disadvantages however. First, if companies are to know the identity of their shareholders, the depository would have to be able to provide registrars with details of first level holdings (i.e. the bank nominee companies and institutions which held accounts with the depository). Even if this were done, legislation would need to be introduced to give account holders direct membership rights, for example, to attend and vote at general meetings, since they would not be the shareholder of record. This is probably a lot more complex than it looks.

5.109. In addition, a depository would increase the amount of shares held in street names. For example, if a private shareholder or an institution wanted to benefit from the system but was not eligible for direct membership, they would need to hold their shares in a broker or bank nominee company that was a member. Such investors forfeit direct shareholder rights and would not be known to companies. The net result could be that company share registers would reveal little of interest. On the other hand, company registrars would have much less work as there would be fewer transfers recorded on the register. In the extreme, there would be only one shareholder, the depository corporation, in each company.

5.110. The principal alternative is an uncertificated system which, by disposing of the need for share ownership to be evidenced by a certificate, allows a two-tier structure (clearing house-registrar) rather than a three-tier structure (clearing house-depository-registrar). A transfer in the books of the clearing house would be a transfer of ownership, as opposed to a transfer of rights and obligations within an account system operated by a depository company which has the direct ownership rights.

5.111. Such uncertificated systems are sometimes described as involving "dematerialisation". This is, however, a misleading label if it is taken to suggest that the system would become paperless. Rather, those shares held in the system would not need to be backed by paper, which after all is the objective. Beyond that, it would not usher in so-called scripless society. In particular, it would not affect the right of investors to hold physical certificates if they choose.

5.112. As with a depository system, direct account holders would probably be limited to brokers, major institutions and nominee companies. In order to improve retail settlement, it would be important that a greater number of small investors held their shares with brokers and bank nominee companies, although large private clients could hold indirect sponsored accounts with the clearing house. In consequence, one of the major advantages of this option is that brokers, banks, major institutional shareholders and sponsored private clients would continue to enjoy direct membership rights and to appear on company registers. The system should therefore not impair the relationship between companies and their main shareholders.

5.113. Nor would the system damage the business of the registrars, as company registers would continue to be meaningful. The registrars would therefore still be required to make regular transfers and to distribute notices etc. to the shareholders on the register. The difference from the present arrangements would be that the registrar would only issue certificates to investors who wished to hold their shares outside the system.

5.114. It would, however, require registrars significantly to improve their performance as the registrar's books would have to keep pace with the clearing house's books. This improvement is in any case desirable as it would bring the benefits of a modernised and more efficient share register system. In particular, company registers would reflect the current state of ownership, not the position some weeks beforehand.

5.115. The disadvantages would be that, although widely used elsewhere, the ideas will be less familiar in Hong Kong. Secondly, the link between the clearing house and

the registrars might take time to develop. However, this should not be a major obstacle given the small number of registrars in Hong Kong and, in particular, the 70% market share of Central Registration Hong Kong Ltd. and, moreover, the system can be introduced gradually, starting with the most actively traded stocks.

5.116. We believe that, given the importance of disclosure and transparency in shareownership, Hong Kong should so far as possible avoid adopting measures which would reduce the number of direct company shareholders.

5.117. We therefore recommend that the central clearing and settlement system should be built on a system of uncertificated book-entry transfers, with the clearing house's transfers being valid instruments of title.

The case for a central guarantee

5.118. Central clearing and settlement typically involves centralising risks through the provision of a clearing house guarantee or bank support. It would, however, be possible to introduce a central clearing system without any guarantee of, or support for, broker performance.

5.119. A major question of principle for the Committee therefore was whether the risks entailed in central clearing can outweigh the operational benefits. The argument against a guarantee is that it is imprudent to concentrate such enormous risks on one party unless it clearly can support and manage those risks. The central guarantor might in fact not eliminate risk as it may be an unsound counterparty because of inadequate resources or poor risk management, or it may not police the soundness of the whole system adequately. If the clearing house is

unable to support the risks it takes, it merely gives an illusion of strength. This is dangerous because professionals, acting in the belief that their only counterparty exposure is to a robust clearing house, may relax their usual credit standards, entering into transactions with other firms irrespective of the fact that some look weak and/or have major clients who they would not trade with directly themselves. This will tend to bolster confidence and increase volumes, thereby adding to the risks assumed by the clearing house and the systemic consequences of those risks crystallising. In other words, if it goes wrong, it goes badly wrong. The failure of the Hong Kong Futures Guarantee Corporation in the October crash illustrates this better than any argument could.

5.120. The absence of a guarantee would, however, leave counterparty exposure with the brokers, which could have serious operational implications if a broker fails to settle (either cash or securities). Moreover, nothing would have been done to reduce the extra counterparty risks arising from the extension of the settlement period recommended earlier this chapter. Finally, a system without a central risk-taker would forfeit the enormous potential advantages of having a single body to monitor and control the risks in the system on the basis of daily information on the position of all the brokers in the market. The monitoring and control function could in principle be undertaken by a central body which did not take any risks, but it would not have the same incentive to manage the risks properly.

5.121. Overseas markets have chosen to take the risk: a central guarantee is universal in futures markets and, since the mid-1970s, has been a feature of many equity markets, including New York and Tokyo.

5.122. On balance, we recommend that the system should be supported by a central risk-taker.

5.123. We examined the main options for establishing a central support: a bank cash and securities lending system and a central clearing house guarantee.

5.124. A bank loan system would involve a bank providing loan facilities for cash and securities to individual broker participants; there would be no guarantee and the facilities would be run on a commercial basis depending on the circumstances of each broker. This is the system operated for Euroclear, by Morgan Guaranty which is the manager of the system.

5.125. This arrangement places a great deal of responsibility and power in the hands of the banks involved as they will need to take credit decisions and be able to monitor brokers' risks; in all probability, a single bank would need to run the system, even if the risks were spread amongst a group of banks. We therefore suspect that this arrangement would be politically unrealistic.

5.126. The advantage of a clearing house guarantee is, first, that the clearing house is at the centre of the system and therefore has all the data needed to do the job. Moreover, a guarantee is a natural extension of its role and is probably essential if a system of continuous net settlement is adopted, whereby open unsettled positions are rolled over to the next day. Finally, the clearing house can lay off its risks with members which should help to maintain collective discipline.

5.127. We therefore recommend that a guarantee should be provided by the clearing house substituting itself as a counterparty to broker trades once certain conditions are satisfied.

5.128. Participants should keep the creditworthiness of the clearing house under active review to ensure that it can support its risks. It should also be required to pass tough tests of its risk management capability. We therefore recommend that it should be subject to authorisation and supervision by the regulatory authority.

Risk management system

5.129. The risks run by the clearing house will vary between broker-broker trades and broker-client trades, as the first are guaranteed and the second are not (under our proposals).

5.130. At their simplest, the risks from providing a guarantee are that a broker will be late in making a cash payment or securities delivery, or that it will fail to satisfy its obligations altogether. Where there is a failure, the clearing house will still have to meet its obligations to the other broker. The guarantee will therefore expose itself to :-

- (a) the credit risk of a member not paying for securities purchased and the clearing house being unable to recover the securities (for example, because they have left the system or have been transferred on to a subsequent purchaser);
- (b) the credit risk of the clearing house releasing payment before securities have been delivered to it (for example, because the member does not have sufficient shares in his account or has not deposited sufficient shares in time); and

- (c) the position risk arising from the clearing house having to purchase securities in the market to make a delivery (because an insolvent broker cannot deliver securities to the clearing house); or having to sell securities to make a payment (because an insolvent broker cannot make a cash payment to the clearing house).

5.131. The clearing house must therefore have strong systems and controls and it must see its role as being primarily risk management and not processing the clearing. One way of reducing the risk of defaulted cash payments would be to set up an assured payments system whereby an individual broker designated a bank which unconditionally undertook to make prompt payments to the clearing house on the receipt of instructions. In other words, the banks would guarantee the performance of their broker clients and the clearing house would substitute bank risk for broker risk. This system which is used in the London gilts market would be desirable in the Hong Kong equity markets but it may not be feasible given the volatility of the instruments and the large number and variety of brokers.

5.132. However, the clearing house will also need other means to control its risks: for example, by imposing financial and information requirements; by working very closely with the SEHK Surveillance Department; and by constructing the guarantee so that the risks, having been concentrated, are unbundled and spread. In particular we recommend that the clearing house should : -

- (a) apply membership requirements including minimum and risk-based capital levels.
While all SEHK brokers should ideally be

members of the clearing house, it should not be obliged to clear the trades of all SEHK members. It must make a risk assessment of each;

- (b) monitor members on an intra-day and day-to-day basis and ensure that there are regular thorough audits of a member's financial and operational position. This should be undertaken in very close co-operation with the SEHK's surveillance unit. In particular, the clearing house should enquire as to the cause of failed settlements and monitor the pattern of settlement activity, projecting net settlement obligations and the impact of daily flows on a member's capital position. It should place a participant under close surveillance and take remedial action if a disturbing position emerges;
- (c) have a lien over securities held in the system by a member (to cover the credit risk);
- (d) establish a Brokers' Fund;
- (e) mark-to-market each member's open unsettled positions on a daily basis, and in fast markets on an intra-day basis. It should call for cash payments or extra fund contributions to cover any adverse movements; and

- (f) take out insurance against a level of defaults exceeding its ability to recover its losses from its members.

5.133. A key element of this proposal is the Brokers' Fund. We believe that each broker who participates in the system and has its market trades guaranteed by the clearing house should make a deposit in the Fund, with the level of contributions based on individual risk positions, subject to a minimum. The clearing house should adjust the size of the Fund according to the ebb and flow of risks in the system, and should call for extra deposits from individual brokers if their risk position increases (for example, because of higher volumes). Non-broker members of the clearing house would not have to contribute to this Fund and nor could they draw on it, as they would not be part of the trade guarantee system.

5.134. It may be possible for the current SEHK Fidelity Fund to be transferred to the clearing house once it is established, as the SEHK would no longer be responsible for compensating members in the event of a broker default.

5.135. Thus, in the event of default, in addition to recoveries and the capital of the broker concerned, the clearing house would draw on :-

- (a) any property of the defaulting member held in the system;
- (b) the defaulting member's deposit in the Members' Fund;
- (c) the remainder of the Members' Fund;
- (d) any insurance taken out; and

- (e) calls for further deposits from its non-defaulting members.

5.136. The broker-client side of the system should be constructed so that clients are only exposed to the broker they have used and not to the risk of a default by other brokers. They should therefore be insulated from the risks the clearing house takes by effectively guaranteeing broker-broker settlement.

5.137. We propose that the clearing house should not guarantee broker-client trades, not least because there is no case in principle for doing so; brokers and clients choose one another whereas brokers are obliged to trade with any other broker. This part of the system will, however, expose the clearing house and the broker, bank and institutional participants. For example, securities may be withdrawn from the system or passed on to another account before payment is received. We therefore recommend that the clearing house should put in place systems and controls to ensure that it avoids releasing securities or cash before the counterparty payment or delivery is received.

5.138. We further recommend that the clearing house should : -

- (a) apply membership requirements to non-brokers and in the first instance membership should probably be restricted;
- (b) take a charge over securities if it is directly exposed to credit risk or if it acts as principal in lending and borrowing stock;

- (c) consider establishing a second fund to protect itself, brokers and their clients against defaults.

5.139. Finally, the clearing house will probably need to insure itself against errors and omissions, fraud, theft etc.

Ownership and control

5.140. As regards ownership of the clearing house, we believe that, whatever system evolves, broker-broker and broker-client clearing and settlement must be managed by the same organisation. Even if a depository were created, it should come under the same roof as the clearing house. We do not support the US arrangement where the exchanges control the clearing house and banks control the depository. We therefore recommend that a single organisation (the clearing house) should be responsible for running the central clearing and settlement system.

5.141. Given its importance to the system, we further recommend that the clearing house should be established by statute or authorised under statute as a non-profit-making corporation. Once it is operating, fee income should enable it to cover its recurrent costs and further enhancement. Any excess of income over expenditure not required for the development and enhancement of the system, could be returned to the participants through rebates.

5.142. As a statutory corporation, there would be no need for owners. However, the initial development costs will need equity financing as well as debt financing. This means there probably should be owners, who will

collectively take responsibility for developing the system and its capital costs. We have no strong objection to this because we believe the owners and developers will have a strong incentive collectively to ensure that the organisation's operations and financial position are properly managed and controlled.

5.143. There are four groups whose co-operation and commitment is fundamental to the success of the system :-

- (a) the SEHK, which must feed trade data to the clearing house and which must work very closely with the clearing house on risk management and surveillance;
- (b) the brokers, whose participation is essential to improve broker-broker settlement;
- (c) the banks, whose participation is essential to improve broker-client settlement given their custodial and nominee functions; and
- (d) the registrars, which will be critical to an uncertificated system.

Possible controllers, therefore, include the SEHK, members of the SEHK, clearing members of the SEHK (if any), outsiders (e.g. banks and registrars), or a combination of these.

5.144. A case has been made for complete or substantial independence from the SEHK on account of the financial risks involved. A completely independent clearing house/guarantor has a clear incentive to manage its risks

prudently and as such should police the whole system effectively. In contrast, the SEHK may have a conflict of interest in so far as it might, for example, delay imposing tougher financial requirements for fear they would reduce volumes. It has also been suggested that the clearing house should be independent from the SEHK on the grounds it should aim to clear and settle all trades in Hong Kong equities, not just trades executed on the SEHK.

5.145. While we have no objection to the clearing house settling non-SEHK trades, we believe there is a strong case for involving the SEHK as this would help to tie the SEHK management to the clearing house management. This is critical if an effective risk monitoring and management system is to be put in place. In this connection, a major international equities clearing house stated to us,

"... exchange member surveillance cannot really be separated from the clearing house's risk management program [sic]. We have tried to overcome this by establishing regulatory linkages and information sharing. By linking the clearing house to the exchange, you can assure yourself that the exchange considers credit (a clearing house concern) at least as important as compliance with market rules."

5.146. In addition there is a political angle to ownership. It is clear from submissions received and discussions with interested parties that ownership of any central body must be spread. We have been told in unequivocal terms that sole control is totally unacceptable. We presume that the objection is to the principle of any central institution being owned by any single body and not reflecting the various interests involved. We agree.

5.147. To ensure that all the different interests are involved, we recommend that the ownership of the clearing house should be split 50/50 between the SEHK and a group of banks (with significant custodial/nominee/registrar operations) acting collectively.

Board

5.148. The board of the organisation would be responsible for policy. All interests should therefore be represented to ensure that policy reflects the views and positions of users generally. In addition, given the importance of the clearing house, its risks and the divergent interests of the various user groups, there should be an outside, non-user element on the board. In summary, we recommend that the board should be broadly representative of the participants and interested parties, and should also have a public interest element. We suggest a 14-member board with three brokers and three bankers, two registrars and four independent members with the Chief Executive of the clearing house and the Chief Executive of SEHK appointed ex officio. The Chairman, to be elected by the board, should be rotated between the brokers and the banks.

5.149. The method of election would depend in part on the decision regarding ownership. But it is for consideration whether, irrespective of the ownership position, all participants in the system should have a right to elect the board and, if so, how this should be achieved. This is a matter which we believe should be sorted out when the system is developed. The following should, however, be borne in mind in deciding the election method :-

- (a) the need to ensure the right balance on the board; and

- (b) the need to ensure the right quality of representation on the board.

Management

5.150. Another important aspect is the management of the organisation. The clearing-house-cum-guarantor could be managed by its own staff, the staff of one of the shareholders, the SEHK, or an independent third party under contract. The first route would ensure independence and security. Moreover, experience overseas, and in particular in the US, demonstrates that it is a specialist profession. Hong Kong's markets would be stronger for such a body. We therefore strongly recommend that the central agency should be run by its own staff.

Summary

5.151. In summary, we recommend the development of a central clearing system in Hong Kong based on book entry transfers of uncertificated shareholdings and run by a central clearing house which guarantees broker-broker trades and whose consequent risks are protected by strong risk management arrangements and a Brokers' Fund. The body should be established as a non-profit-making statutory organisation governed by a board broadly representative of the participants and interested parties together with an independent public interest element, managed by its own professional staff and with ownership shared 50/50 between the SEHK on the one hand, and a group of banks and other interested in share settlement on the other.

SURVEILLANCE OF MEMBERS

5.152. Members of the SEHK are subject to regulation and surveillance by the Exchange which has a variety of powers to police and enforce its Rules. Broadly speaking, the objectives of such supervision are to ensure the integrity and honesty of members, especially with regard to their dealings with clients, and to ensure that they are financially sound to conduct the business of dealing in securities.

5.153. The powers of the SEHK's Surveillance Department to monitor the financial position of members are set out in the Rules of the Exchange. The more important provisions are : -

- (a) the SEHK can increase the minimum net capital and liquidity margin requirements, and take action if a member cannot comply with the requirements;
- (b) a member must appoint an auditor to audit his accounts;
- (c) a member must keep records in sufficient detail about his trading activities, including records relating to trust accounts and clients' securities;
- (d) a member must maintain one or more trust accounts and keep separate accounts for every client in respect of dealing in securities;

- (e) a member must submit quarterly returns and annual accounts to the Exchange; and
- (f) the SEHK has the right to demand documents and to make surprise checks to inspect a member's books, accounts and records.

5.154. As at end January 1988, the SEHK's Surveillance Department had a total of 15 staff, including two qualified accountants.

5.155. The major complaints raised in the submissions regarding the Exchange's surveillance activities were : -

- (a) staffing in the Surveillance Department was inadequate and there were insufficient qualified staff to discharge the SEHK's supervisory functions effectively;
- (b) supervision of members was not conducted actively and diligently. Its regulatory function consisted primarily of receiving but not critically reviewing the quarterly returns and annual accounts of members; and
- (c) in any event reports produced by the Surveillance Department were not followed up.

5.156. As a membership organisation, the SEHK has a clear obligation to regulate its members, to ensure that they abide by the rules of the SEHK and, in particular, that they are reliable counterparties to other members trading on the Exchange. To fulfil this role, there is an urgent need to improve the SEHK's surveillance capabilities.

5.157. The main areas requiring reforms are as follows: -

- (a) a clear programme for monitoring members financial position should be introduced, with particular emphasis on their trading records and accounts. The existing system of cursory review of a member's quarterly and annual accounts is clearly insufficient. Consideration should be given to requiring monthly rather than quarterly reports⁽²¹⁾ given how quickly a member's position can deteriorate. In addition, the Exchange should institute a system of annual or biennial inspection visits, carried out either by SEHK staff or an outside audit firm approved and appointed by the SEHK, coupled with audits of members suspected to be in breach of the rules;
- (b) a system of early warning triggers should be introduced - such as capital falling below a certain level above the minimum requirement - so that the Exchange can identify and work to resolve problems at an early stage;
- (c) requirements and reporting arrangements should be introduced regarding risk concentrations, such as large exposures to a single person or group of related counterparties and large positions in individual securities relative to capital; and

(21) The HKFE has recently moved to monthly reporting.

(d) a system for reviewing members' trading activities should be instituted. Exception trading reports should be produced and regularly monitored to identify unusual activities that might indicate problem areas or malpractices. These should be followed up vigorously.

The emphasis in every case should be on problems of substance.

5.158. We are aware of the reforms recently initiated by the SEHK to strengthen its Surveillance Department and to devise the necessary procedures for the better surveillance of member firms⁽²²⁾. In essence, these reforms involve the development of more meaningful financial returns, greater use of external auditors (i.e. auditors appointed by members), a revised inspection routine and a reorganised reporting structure that would help to provide a disciplined reporting environment and definite follow-up procedures. In addition, the Exchange envisages a substantial enhancement of the Surveillance Department staff, both in calibre and experience to discharge its regulatory functions.

5.159. We are generally content with the SEHK proposals and believe that such reforms should substantially improve the situation. We believe, however, that apart from surveillance of members' financial position to ensure that they are in a position to discharge their liabilities at all times, the SEHK should also step up its surveillance of members' relations with their clients. The latter should aim at ensuring that members are conducting their business

(22) It should be noted that, in the period following the October crash, the Exchange suspended a number of brokers and appointed inspectors to many more.

according to high standards, that investors are being provided with the necessary protection and that settlement is prompt.

5.160. The strengthening of the Exchange's surveillance capability and systems is an on-going business. Such efforts must not be undermined by a lack of will or resources. In order to emphasise the importance we attach to this effort, we recommend that the regulatory authority should review the development of the SEHK's surveillance arrangements within 12 months of its establishment.

5.161. Finally we would stress again that, once a central clearing system is introduced, the Exchange surveillance team must work very closely with the clearing house. The latter's risk management arrangements should be central to the monitoring of brokers. There should be daily contact between the two, with complete openness and information flows both ways. The clearing house should be able to request the Exchange surveillance team to investigate a broker and should be able to expect that such requests will be met. This is, in our view, essential if the clearing house is to succeed; every available measure should be taken to ensure that the equity market does not reproduce the muddled relationship between the Futures Exchange and the futures market clearing house prior to October 1987 (see Chapter VII below).

CHAPTER VI

THE FUTURES EXCHANGE

FUTURE AND MANAGEMENT

INTRODUCTION

6.1. Following the October 1987 crash, a rescue facility of HK\$4 billion - equivalent to roughly US\$500 million - had to be put together to save the Hong Kong futures market from the threat of permanent closure. Since then, despite the measures which have been taken to improve its management and the wide-ranging reforms to preserve the market's future, there have been calls from a number of quarters to close the market, or at least to cease trading the Hang Seng Index Futures contract (HSI contract). Our review of the Hong Kong Futures Exchange (HKFE) therefore started with an examination of the question whether the Exchange and HSI contract should continue. Thereafter, we examined the constitution, management and operations of the Exchange.

6.2. In this chapter, after providing a brief layman's introduction to futures trading, we deal first with the question of the future of the Exchange and the HSI contract before we go on to examine the constitution and management of the Exchange. In the following two chapters, we examine in turn the risk management structure and the trading controls and surveillance systems of the Exchange.

BACKGROUND

Futures trading

6.3. In general, a futures contract is an agreement to deliver (or take delivery of) a specified quantity and quality of a certain commodity at a specified time and place. A futures exchange is a place where futures contracts with standardised contract terms are traded according to strict rules by member dealers supervised by the exchange's staff. Trading is typically by open-outcry; the dealers in a particular contract gather together in a "pit" or "ring" on the exchange floor and call out prices until a buyer and a seller⁽¹⁾ agree a price.

6.4. Futures contracts are used for a variety of purposes, but fundamentally they are instruments for transferring risk. If a person holding a commodity wishes to protect himself against the risk of a fall in its value he may sell futures contracts; falls in the value of the commodity would be offset by corresponding gains in the futures market; this person is called a **hedger**⁽²⁾. The corresponding buyer may be a **speculator** who believes the value of the commodity will rise but who is prepared to take the risk of the price falling. A third type of trader is the **arbitrageur** who seeks to exploit short run divergences between the price of the commodity in the cash market⁽³⁾ and the price of the futures contract.

(1) A trader enters into a contract to deliver (the equivalent of "sell") or take delivery (the equivalent of "buy").

(2) Hedgers can in fact operate on both sides of the market.

(3) The term "cash market" refers to the underlying commodity market where trades are for immediate delivery.

6.5. Historically, most futures contracts have been based on commodities, such as wheat, coffee, cotton and copper although almost any commodity can form the basis of a futures contract. Examples include live hogs, fresh eggs and the famous pork bellies. Such contracts have a long history, but recent years have seen the development of contracts based on financial instruments, such as bond futures.

6.6. In 1982 in the US, stock index futures were traded for the first time. The underlying basis of a stock index future is the concept of the future delivery of a basket of shares comprising an index. However, in contrast to most futures contracts, stock index futures are normally settled in cash rather than by physical delivery of actual shares. They, therefore, represent an obligation to pay (or a right to receive) an amount of cash determined by the difference between the price at which the contract was struck and the value of the index at the settlement date (which in Hong Kong may be one, two or three months ahead). As such, they are "contracts for differences".

6.7. As with other types of futures, stock index futures may be used by hedgers, speculators and arbitrageurs, and for other trading strategies - some of these are described in Appendix 21.

6.8. Virtually all futures markets have central arrangements for registering, clearing and settling contracts. Usually, the central clearing house provides a guarantee of performance to the traders, so that they are not exposed to credit risk from other brokers. Their exposures are thereby limited to the market risk of prices moving and to their clients. The clearing house may be a

(4)
division of the exchange or it may be separate .

6.9. Because it provides a guarantee, the clearing house has arrangements for controlling its risks, over and above any exchange requirements regarding membership, capital levels etc. Principal amongst these is the system of collecting margin and daily settlement. Briefly, the clearing house requires the brokers whose trades it guarantees (the clearing members) to place with it an amount of money (or property) which will protect it against a move in prices in the event of a broker's default. This is discussed in greater detail in Chapter VIII below.

The Hong Kong futures market

6.10. Although there has been an active gold market in Hong Kong since 1910, commodity futures trading did not get underway until 1977 when the Hong Kong Commodities Exchange opened to trade cotton and sugar futures, with soyabeans and gold contracts following in 1979 and 1980 respectively. The cotton market closed in 1981 and trading in the other markets has always been thin.

6.11. The Exchange took on a new lease of life in May 1986 when, after a Government review and a consequent major management reshuffle, the HSI contract was launched. Shortly beforehand, as a signal of its new direction and emphasis on financial products, the Exchange had been renamed the Hong Kong Futures Exchange Limited⁽⁵⁾ (HKFE).

(4) As discussed in Chapter VII below, in Hong Kong the clearing house is independent and, unusually, the guarantee is provided by a third party.

(5) Appendix 22 contains a brief history of the Exchange.

6.12. After a slightly nervous start, the HSI contract boomed. Within ten months, turnover was over 200,000 contracts per month and the aggregate net open interest had risen to 14,000 contracts. During 1987, turnover hit a record of 40,000 contracts per day, the net open position⁽⁶⁾ grew to nearly 38,000 contracts. The Exchange management announced that the HSI market was the second largest stock index market in the world, trailing only the Chicago Mercantile Exchange's S&P 500 contract⁽⁷⁾.

6.13. What the protagonists failed to notice was that activity had far outstripped the capacity and capability of the risk control arrangements at the Exchange and the clearing house, ICCH (Hong Kong) Limited (ICCH(HK)), and that the make-up of the market was unbalanced.

The October 1987 failure

6.14. The events of the October crash are described in Appendix 1. Briefly, as the stock market was bound to crash upon re-opening on 26 October 1987, it was known that the value of long futures contracts in the HSI futures market would plummet, prompting massive defaults on any new margin call. The scale of the expected defaults was considerably greater than the Hong Kong Futures Guarantee Corporation's resources and it was therefore rescued by a group of banks, brokers (most with short futures positions)

(6) Net open interest is the difference between a broker's long and short positions.

(7) But see paragraph 3.4 above.

and the Government. Of the total of \$4 billion of facilities arranged, almost \$2 billion had to be drawn down.

Exchange review and reforms

6.15. While the October crisis was unravelling, the Government put new management into the Exchange. Their first job, together with the clearing house, was to handle the re-opening of the market on 26 October 1987. Subsequently, they reviewed the events leading up to the collapse and identified a number of weaknesses in the market, including the following :-

- (a) **market structure.** All traders in the market were members of the clearing house, with the consequence that the central guarantor, the Futures Guarantee Corporation, was directly exposed to the entire market;
- (b) **margin enforcement.** Many brokers had not diligently and promptly collected margin from their clients;
- (c) **capital requirements.** Brokers did not have sufficient capital to support the risks they were taking;
- (d) **client understanding.** Many clients claimed they had not fully understood that, by entering into a futures contract, they were taking on an open-ended risk;
- (e) **risk concentrations.** A few brokers accounted for most of the activity and a

handful of clients accounted for around half the net open interest on the long side of the market; and

- (f) surveillance and risk controls. The build up of risk had not been appreciated and combatted.

6.16. In December 1987 new management at the Exchange responded to these problems by proposing wide-ranging reforms of the market and the introduction of new, tougher trading controls. These included increased capital requirements and, in particular, in order to develop a tiered market, high requirements for clearing members and low requirements for a new category of "locals" or floor traders who may only trade for their own account and not for clients; better client risk disclosure rules; the introduction of limits on the number of positions a broker may hold relative to its net worth; and strengthening surveillance through, inter alia, more frequent statistical reporting. The guarantee and clearing house risk management arrangements continued but with gross margining. These are discussed in greater detail in the following two chapters.

FUTURE OF THE FUTURES MARKET

6.17. Notwithstanding the measures taken to strengthen the HKFE's management and the fairly comprehensive reform package which is already being implemented, some commentators and submissions called for more drastic action. Some have argued that the Exchange should be closed and others have argued that, even if the Exchange continues, HSI futures trading should cease. Others still have maintained that the Exchange is not commercially

viable and should close anyway, irrespective of the merits or demerits of futures trading.

6.18. Our first concern was therefore whether the Exchange and the HSI contract⁽⁸⁾ should continue and, if so, what reforms are needed to safeguard against a repeat of October 1987.

Viability of the Exchange

6.19. There is little doubt that the continued viability of the Exchange is in question. Since 19 October 1987 turnover in the HSI contract has fallen sharply, averaging less than 800 per day. This has adversely affected Exchange income during a period when expenses are rising on account of improvements to the surveillance and other departments. Although the Exchange had net assets of approximately \$65 million as at end-1987, future viability depends on activity in the HSI market picking up or the introduction of successful new contracts.

6.20. However, we feel strongly that the question of viability is not for us or, in our view, for Hong Kong's regulatory authorities. It is a commercial matter for the Exchange's board of directors.

Desirability of a stock index futures market

6.21. In view of the strength of feelings generated by the collapse of the HSI market, we believe it is important

(8) We have not reviewed the other contracts traded on the HKFE, although the Exchange has indicated it wishes to do this, and we believe that the regulatory authorities should do so in the near future.

that we address whether the stock index contract itself should continue.

6.22. The general arguments in support of stock index futures are that they enable risk transfer at relatively low cost and thereby increase fund management flexibility. This might attract more funds into the market by protecting investors against sharp price falls⁽⁹⁾. In addition, they might help the market to respond more quickly to new information.

6.23. Against that, it has been argued that there is a fundamental asymmetry in the market. The argument is that the long side of a stock index futures market will tend to be predominantly speculative because the world is long in equities and cash market settlement periods are short. Moreover, as speculative activity is encouraged by the low cost of entering the market, in particular the greater leverage that can be achieved in the futures market as opposed to the cash market, this might lead to the overall value of the stock market being determined on the futures floor, with the Stock Exchange's price determination role relegated to relativities between individual index components. Some opponents maintain that stock index futures are a gambling instrument which can fuel a speculative boom; they compare this to the 1920s boom in the US, when speculators are said to have sold short on low margins.

6.24. In particular, it is argued that stock index futures might increase price volatility, making

(9) It became apparent during our discussions with market players that this weighed quite heavily with US intermediaries and fund managers (who we believe Hong Kong should aim to attract) although the same investors stressed that the market must be well managed and regulated for them to use it.

investment and new issue decisions more difficult (10) .

6.25. A second line of criticism is that, while stock index futures trading might not increase volatility in normal trading conditions, complex trading strategies on the index futures market might actually bring about or seriously exacerbate or accelerate a fall if the market is undergoing a severe adjustment. Such a so-called cascade could come about in a variety of ways. For example, a sharp fall in the stock market triggers futures selling by investors who wish to hedge their portfolios⁽¹¹⁾ which causes the emergence of a significant discount to the cash market; this in turn prompts large arbitrage programmes, with arbitrageurs buying the future and selling in the stock market which further depresses stockprices and thus triggers another round of selling by the portfolio insurers; and so on.

6.26. All these points were made about Hong Kong. The futures market was said to have increased volatility, although no proof was advanced. The cascade scenario was mentioned, but without evidence that it had occurred in Hong Kong. Futures markets were castigated as gambling casinos, without any acknowledgement of the critical role played by speculators in providing liquidity and thus in helping futures markets to provide hedging opportunities. (We should point out that we were equally unimpressed, however, by arguments that seek to justify futures with the bold claim that, by virtue of increasing market liquidity through enabling low cost trading, they reduce the cost of capital.)

(10) US research on the pre-crash period has indicated that there has not been a statistically significant increase in inter-day volatility since 1982 (when stock index futures were introduced).

(11) Generally referred to as portfolio insurers - see Appendix 21.

6.27. While we are not convinced that a stock index futures market, or indeed a financial futures exchange, is essential to Hong Kong, we would distinguish between not establishing a new market and closing an existing one. We have little doubt that a decision by the authorities to bar stock index futures trading here would be interpreted by overseas observers as a sign that Hong Kong did not feel capable of managing a futures market prudently. This could have the unintended effect of damaging its other markets by weakening confidence in the system. This is, however, not a sufficient reason to keep the market open.

The Hang Seng Index futures market

6.28. We concluded that it was clearly insufficient to reach a view on the basis of generalised arguments and that a more detailed examination of the nature of the Hong Kong market was required. The main issues that needed to be addressed were : whether stock index futures in general have inherent defects and expose markets to undue risks; whether the construction of the HSI futures contract in particular is defective; and whether Hong Kong cannot support a balanced and stable stock index futures contract because of the nature of its particular market and players.

6.29. We therefore undertook a brief review of the HSI market from its launch in May 1986 up to October 1987. This was based on quantitative information provided by the Exchange and ICCH(HK) and anecdotal evidence from some of the major players⁽¹²⁾. A summary is at Appendix 23.

(12) We accepted anecdotal evidence as we were faced with a lack of hard data and felt that, given the relative narrowness of the market and the small number of major players, we could place some reliance on qualitative descriptions.

6.30. Briefly, the review indicated, first, that there was no statistically significant increase in the inter-day volatility of the cash market following the launch of the HSI futures contract⁽¹³⁾; although intra-day volatility may have increased.

6.31. As to the character of the market, the statistics indicate that client interest consistently accounted for over 90% of the net open interest in the market⁽¹⁴⁾. With the level of house account net open interest remaining fairly steady during the summer of 1987, the entire increase in net open interest during the period June to September 1987 was the result of a phenomenal growth in client interest.

6.32. It was also apparent that the long side was almost entirely speculative with a significant retail element while institutional arbitrageurs comprised a major element of the short side of the market. It was unclear how much it had been used by hedgers; not least because of difficulties in distinguishing between hedgers and arbitrageurs. One or two index funds had been active in Hong Kong and had used the futures market for index substitution and engaged in arbitrage. But portfolio insurance had not been used in Hong Kong.

6.33. The exceptionally profitable arbitrage opportunities that arose, especially during the summer of 1987, suggested that the market was not particularly efficient in that the speculative interest on the long side of the market consistently outweighed hedgers and arbitrageurs selling short.

(13) This is based on the conclusions of Andrew F Freris in "Hang Seng Index Futures and the Stability of the Equity Market in Hong Kong", Discussion Paper, Department of Economics, University of Hong Kong.

(14) Brokers may trade for their own account (house account), or for their customers (client account).

6.34. Furthermore it was also clear that, quite apart from the large positions built up by a handful of investors on the long side of the market, the market had been dominated by a few brokers. At the time of the collapse, although there were 102 brokers, five brokers accounted for roughly 80% of the short side of the market.

The role of futures in the crash

6.35. The most important question, however, was whether the futures market had caused or exacerbated the October crash. We are fairly confident that there is little, if any, evidence to suggest that Hong Kong was the victim of the so-called cascade scenario. We do not think that the interplay of complex trading strategies on the futures market triggered the fall on the SEHK. In this respect, we note that futures did not trade at a discount to the cash market on either 16 or 19 October and we have seen no evidence to suggest that futures market strategies were the cause of significant cash market sales, although of course it is not clear what would have happened if the markets had remained open and there had not been major defaults.

6.36. However, there is equally little doubt that the overhang of long arbitrage positions was a severely complicating factor during the crash. If the guarantee corporation had defaulted, the long arbitrageurs would have had to unwind their positions on the cash market, estimated to involve the sale of between \$4bn and \$6bn worth of shares, compared with average SEHK daily volumes of \$2.7bn during September and \$3.9bn in the final run up to 19 October 1987. This would have doubled the selling pressure of \$4.5bn worth of trades which eventually hit the stock market on 26 October, depressing stock prices still further and creating a prospect of stockbroker failures with possible knock-on effects elsewhere in the system.

6.37. It has been argued that, although the settlement backlog was the official reason given for closing the SEHK for four days, the actual reason was the prospect of major losses on the futures market. Unlike stock market losses, futures market losses are immediate cash losses because of the daily settlement procedure. Those who maintain this line argue that the SEHK hoped the market would recover by the weekend of 24 October thereby avoiding huge losses for the holders of long futures positions. It is impossible for us to form a view on the substance of this complaint. However, we note that the root of the argument is that investors with large long futures positions were unable or unwilling to support their positions in the event of a price collapse. In our view, this is a problem of regulation, not of the inherent features of the market.

6.38. It has been suggested that the futures market contributed indirectly to the crash by artificially inflating prices, to a point where they were bound to fall sharply. In principle this could happen through investors extending their positions in the stockmarket because of the availability of hedging facilities in the futures market; or through the overall price level of the market being determined on the Futures Exchange floor and transmitted to the stockmarket via arbitrage. A variant of this, which has been given some publicity⁽¹⁵⁾, maintains that Hong Kong was gripped in an upward spiral. The argument runs as follows : seeing stockmarket prices rise, speculators invested heavily in lower-cost futures. This created a premium between the futures and cash market which prompted arbitrageurs to buy heavily in the stockmarket, pushing prices up further, encouraging more speculators into the futures market, and so on.

(15) See Hong Kong Standard, 28 March 1988.

6.39. However, there is no clear evidence to support this interpretation of the stock market rise.

6.40. There can be no doubt that attractive arbitrage opportunities on the Futures Exchange did increase stock market volumes and prices, as arbitrageurs were buying shares at current values purely to lock into a fixed return and not because of a fundamental interest in the investment itself. But we note that trading directly attributable to index arbitrage generally accounted for less than 5% of daily stock market volumes⁽¹⁶⁾.

6.41. As to the argument that, because of the very rapid increase in HSIF daily volumes and high levels of arbitrage activity, prices were being driven up in the futures market and transmitted to the SEHK, we should stress that inter-day volatility on the stockmarket has not changed significantly since the futures contract was introduced. This appears to suggest that the futures market has not caused stockmarket prices to increase more rapidly.

6.42. Volumes which were already high at the beginning of 1987 more than doubled in both markets by September. We believe that the interest in the long side of the futures market was in part promoted by futures brokers who did not enforce the required minimum margin requirements, equally, brokers on the stock market were allowing their clients to trade extensively on credit. We therefore suspect that the rise in prices was fuelled by lax credit extensions and increasing confidence that the bull market would continue. Although market linkages increased the volume of trading, it is not clear that this was by a substantial amount.

(16) See Appendix 23.

Small speculators and the HSI futures contract

6.43. We were concerned, however, at the extent of small retail involvement on the speculative side of the market, particularly if the allegations that margin requirements were not being enforced and that clients did not understand the extent of their exposures are true. While regulatory measures have been taken by the Exchange to address these allegations we believe that the problem runs deeper : the features of the contract itself might have had the effect of underpinning excessive speculation.

6.44. First, with a contract multiplier of \$50, the value of an HSI future is one-fifth of the FTSE 100 future in London and one-eighth of the S&P 500 future in Chicago (at current prices). While we should stress that speculators are essential to a healthy futures market because they provide liquidity, we believe that too cheap a contract may encourage those without the necessary resources to enter the market. This is a legitimate concern particularly given the unequivocal stipulation by the Legislative Council in 1975 that the establishment of a commodity exchange in Hong Kong should be made subject to the proviso that social hazards to the ordinary citizen should be minimised. An increase in the contract multiplier to two or three times its current size might help to tip the balance of the market away from the small retail investor.

6.45. Second, trading is for one, two and three months out, rather than the usual international practice of three, six and nine months⁽¹⁷⁾. Since speculators are loathe

(17) We believe that the attachment to 3, 6 and 9 months may be related to agricultural seasons.

to look far ahead on account of the volatility of equity markets, short contracts could perhaps be defended on the grounds that they increase volumes and add to the liquidity of markets. They might, however, encourage reckless speculation by providing an apparently safe time horizon, which of course in the event was not safe. Furthermore, unless market are particularly buoyant as they were last summer, activity might concentrate at the short end so that hedgers, for whom the market exists, might not be able to hedge for any reasonable period. This could act as a disincentive to their using the market. However, it is important not to lose sight of the fact that retail investors were encouraged by discounted margin requirements and active marketing by brokers.

The Hang Seng Index

6.46. There is a further possible problem with the contract : the construction of the Hang Seng Index itself. As explained in Appendix 23, the index represents only 33 stocks, and is capitalisation weighted. In consequence, a handful of major shares have a very heavy impact on the level of the index⁽¹⁸⁾. While the HSI reflects structural features of the market, such as the dominance of a few companies and the extensive cross-holdings, it may not necessarily be a sound basis for a futures contract.

6.47. Trading in an index which can be distorted by significant moves in a few stocks may feed back into the stock market as a whole on account of trading strategies which tie the two markets together (such as arbitrage),

(18) At the end of February 1988, one company, Hong Kong Telecommunications Ltd, accounted for 20% of the index, yet only 9% of its shares were in public hands.

particularly if investor portfolios do not perfectly match the composition of the index. This can be avoided by replicating the index but that may not necessarily be the best investment strategy.

6.48. Furthermore, it has been put to us that both the index components and the futures market have occasionally been subject to manipulation. Although no evidence has been provided it was suggested that this happened in the weeks leading up to the October crash, with large futures purchases being promoted by rumours of a bid for a major company⁽¹⁹⁾. This would be of particular concern if a play on an individual stock could affect the whole index and filter through to futures trading.

6.49. Finally, it has been suggested that the bar on short selling in the stock market causes an imbalance in the market since there are no cash shorts hedging their book by taking up long futures market positions. This leaves all hedgers and arbitrageurs on one side with speculators on the other⁽²⁰⁾.

6.50. Against this background, we believe that the underlying cause of Hong Kong's unique experience of the October collapse was poor risk management and lax credit controls in both markets and at every level of the system, from individual brokers through to the futures market clearing house rather than the essential inherent features of the HSI futures contract.

(19) Hong Kong Land Company Limited.

(20) See Chapter V above and Chapter XIII below.

Conclusions

6.51. We formed the view that, while the futures market had weaknesses which went beyond the lack of risk management controls, it could not be blamed for the crash, although it did undoubtedly severely complicate its course because of the extraordinary level of defaults. Moreover, the market had some positive features, not least of which was the high level of institutional and international interest, albeit on only one side of the market.

6.52. We have therefore concluded that the HSI contract should not be dropped on regulatory grounds provided that sufficient safeguards and risk management controls are in place to prevent a recurrence of October 1987.

6.53. In the light of the comments above, we further recommend that the Exchange should review the Hang Seng Index futures contract. This review should focus, first, on the contract terms and, in particular, the contract multiplier and contract months. Secondly, it should cover whether the Hang Seng Index is the best available index to form the basis of a futures contract (which, we should emphasise again, should be distinguished from whether it is the best measure of stock market activity). The review should involve wide consultation within the market and with markets overseas which have experience with stock index futures. We should stress, however, that calling for a review does not indicate that the HSI market is unsafe in the meantime - that depends on the adequacy of risk controls. But the regulatory regime must take account of any potential problems created by weaknesses in the contract, and be on guard against possible exposure to manipulation. It is also important that, as discussed in Chapter XIII below, the linkages between the stock and

futures markets should be smooth and efficient. Any weaknesses should therefore be resolved.

6.54. Some people have argued that the HSI futures contract should continue but that it should be moved to the Stock Exchange on the grounds that fundamental and derivative products should be traded under the same roof and that, given its much greater financial resources, the SEHK is better placed to ensure that proper regulatory and risk management arrangements are put in place.

6.55. We do not agree, although there could be no objection to the SEHK stepping into the breach, again provided the necessary trading controls were in place, if the HKFE does not succeed. We believe that the HKFE under its new management has shown itself prepared and able to grapple with the needed reforms. In addition to having no experience of futures products, the SEHK has enough problems of its own to deal with.

6.56. We therefore conclude that the HSI futures market should remain with the HKFE. In Chapters VII and VIII below, we consider the necessary safeguards and the reforms already introduced by the Exchange.

6.57. As well as continuing with the HSI, the Exchange would like to introduce new contracts to strengthen its business and, in particular, has been considering an interest rate futures contract, which it is hoped would broaden the participation of the market by attracting banks and other major institutions. A range of financial derivative products would also diversify the clearing house's risks and could add to Hong Kong's attractions as a regional capital market. We note that these are objectives which we have already stressed in Chapter III.

6.58. However, this raises the question of safeguards. In the following chapter, we identify fundamental structural defects in the current risk management arrangements, the most important of which are the lack of a members' fund and clearing house involvement in active day-to-day monitoring and surveillance. In our view, unless and until these defects are positively rectified to the satisfaction of the regulatory authority, no new contract should be introduced. In particular, we recommend that that the introduction of a new contract should depend on : -

- (a) the Exchange being satisfied that all the clearing members for the new contract are robust and the new market will be adequately tiered;
- (b) a members' fund being established to support the risks of clearing the new contract;
- (c) the Exchange taking de-facto control of the risk management aspect of the clearing function for the new contract, with the clearing house answerable to the Exchange's senior management on a day-to-day basis; and
- (d) the regulatory authority being satisfied that adequate safeguards for the new contract concerned are in place.

CONSTITUTION

6.59. Having concluded that the future of the HKFE is a commercial decision for the Exchange Board to decide and

that the HSI contract should not be dropped, we now turn to consider the constitution, management and membership of the Exchange.

6.60. We believe that many of the objectives we set for the SEHK in the preamble to Chapter IV apply equally to the Futures Exchange. A number of the recommendations in this chapter relating to the constitution and management of the Futures Exchange therefore reflect our recommendations in respect of the Stock Exchange. We do not intend to repeat all the arguments which led to those recommendations.

6.61. The Hong Kong Futures Exchange Limited is a limited company owned by its shareholders. It is licensed by the Governor in Council under section 13 of the Commodities Trading Ordinance to operate a commodity futures exchange and has the only such licence in Hong Kong. It thus enjoys a monopoly.

Status of the Exchange

6.62. Under its Articles, the HKFE may pay dividends. Although its profit record is unremarkable, it has in the past been operated as a profit-making company⁽²¹⁾. We believe that, as with the SEHK⁽²²⁾, the HKFE should operate more like a public utility in the interests of its users and the wider public. We therefore recommend that the Exchange's Articles of Association should be amended to remove all dividend provisions and to state in express terms that it is a non-profit-making company.

(21) It has never paid a dividend.

(22) See Chapter IV above.

The governing body

6.63. Under the Exchange's Articles of Association, management and control of the Exchange are vested in the Board of Directors. The Board is given extensive powers by the Articles, and in particular may make rules without referring to shareholders(23). Such rules cover, inter alia, qualifications for membership, trading practices and disciplinary procedures. Members not complying with any rules are liable to discipline. The Board also has specific powers relating to the management of the Exchange, the control of its staff, the use of its funds and the expulsion of its shareholders.

6.64. Following the re-organisation of the Exchange in 1985, the provisions relating to the appointment of the Board were substantially amended. In particular, all twelve directors were appointed by the Administration in the first year after re-organisation, 1985/86. This was to unwind over three years, with one third of the government appointees retiring each year and their replacements being elected by shareholders. The Chairman and the three Vice-Chairmen, by virtue of Article 52(d), were the final appointees to be required to resign. Following the events of October 1987, however, the last Board did not serve its full term as a largely new Board was appointed in the week commencing 26 October 1987.

6.65. The Articles provide for reversion to a more orthodox method of Board selection at the 1988 AGM. In consequence, virtually all members of the present Board will be required to retire from office in September 1988, with the Board for 1988/89, comprised exclusively of members of the Exchange, being elected by shareholders.

(23) Article 73. The Board has to obtain the approval of the Commodities Trading Commission under s.14(2)(d) of the Commodities Trading Ordinance.

6.66. We are in no doubt that new arrangements for the election of the Board should be introduced before the 1988 AGM. First, until October 1987, the HKFE did not operate particularly effectively and its board was not representative of the market. In this connection we would note in particular the Vercelli Agreement⁽²⁴⁾ which enabled a company controlled by some HKFE directors to participate in ICCH(HK) profits and the previous Board's alleged initial support for a ring out following the October 19 collapse⁽²⁵⁾.

6.67. We believe that, unless a new constitution is introduced, there is a risk of a return to the old ways and in any case, that an opportunity for reform will have been lost. We therefore advocate a similar (but not identical) board structure to the SEHK (see Chapter IV). A number of differences should be highlighted, however.

6.68. In our view, the HKFE board and Nominating Committee do not need to be as large as the equivalent SEHK groups. Second, the futures market divides into functional constituencies as there are different categories of trader (GCM, ICM, non-clearing members etc)⁽²⁶⁾ and different

(24) See Appendix 22 for a brief summary.

(25) By rule 602 the General Manager if satisfied that "there exists an economic or financial crisis" may require open contracts "to be invoiced back at prices as determined by the Market Division Committee of the respective commodity markets", i.e. a ring out. Such a provision is not unusual in soft commodity markets where the danger of physical delivery being prevented exists. But for financial products, like the HSI contract, physical delivery is not contemplated and such a ring out clause is unusual.

(26) There is also a distinction between full members who may trade on every market and market members who are confined to one.

contract markets (soyabeans, HSI etc). We propose that the Articles should require a balanced Board drawn from these various groups.

6.69. Third, we believe that the Nominating Committee should put forward candidates for election for all places. In the first year we propose that the market should not be able to propose rival candidates and that the Nominating Committee should put up more candidates than places. Thereafter, the Nominating Committee would nominate a sufficiency of candidates and rivals would be permitted.

6.70. Fourth, notwithstanding that the Exchange staff is currently headed by an executive vice chairman, we believe that, while the chief executive should be on the Board, he should not be a vice chairman. Nor should he be the chairman as was the case before October 1987. A market-related chairman supported by a fully independent chief executive would achieve the objectives we set in Chapter III.

6.71. Fifth, we believe that independent, non futures trader members of the Futures Exchange board are particularly important given the conflicts of interest which would arise from our proposal in the following chapter that the clearing house should become part of the Exchange and that a clearing house guarantee should be backed by, inter alia, a clearing members' fund.

6.72. We therefore recommend that the Articles of Association of the HKFE should be amended to require that the Board be broadly based and representative of the market, users of the market and the public interest and that the Board should incorporate : -

- (a) eight full or market members elected from the membership of the Exchange;
- (b) four independent members with full voting rights, co-opted by the Board; and
- (c) the Chief Executive ex officio.

6.73. In order to achieve an appropriate balance among the market members we recommend that at least one general clearing member, one independent clearing member, one non-clearing member and one floor member should serve on the Board provided that there is a sufficiency of candidates in each class. Separately there should be a requirement that there should be at least one soft commodity futures trader and one financial futures trader on the Board.

6.74. The addition of the Chief Executive will increase the membership of the Board to 13. Apart from the Chief Executive, who should serve as a director of the HKFE as long as he holds office, the members should serve, as at present, for a three year term. Unlike the SEHK, we see no reason to change the name of the Board to the Council (see para. 4.28 above).

Elections

6.75. For the reasons explained in para. 4.50 above the HKFE will need a Nominating Committee. We recommend that the Nominating Committee should comprise one independent member of the Board, two full or market members not on the Board, and one independent. One of the independents should chair. After the first year the Committee would be appointed by the Board. It would be charged with producing

a slate of candidates for election to the Board which would satisfy the general requirements of the Articles and the specific requirements set out in para. 6.72 above. In doing this the Nominating Committee would also need to bear in mind the need to produce an appropriate balance of local and international interests among the traders. For the first year only, the Nominating Committee should be allowed to put forward candidates and they should present at least 12 for the eight elected places on the Board so that members have a real choice when voting. Thereafter, we believe that it will be sufficient for the Nominating Committee to put forward as many candidates as there are vacancies (2 or 3 in each year) with additional candidates put forward, if they wish, by the market members.

6.76. We recommend that the Chairman of the Board of the HKFE should be elected by the Board from among its members to serve for one year. His term of office should be renewable twice. There should be two vice-chairmen elected by the Board, one of whom should be an independent member of the Board unless the chairman is himself an independent member.

6.77. We recommend that voting in Board elections should be on the basis of one-share-one-vote⁽²⁷⁾. Elections should be in person, with no proxies, by secret ballot and subject to vetting by independent scrutineers. The transitional measures and permanent safeguards in respect of SEHK elections described in paras. 4.67 and 4.68 above should apply mutatis mutandis to the HKFE. In summary, we recommend that : -

(27) But see paras. 6.87 on membership below.

- (a) the first four independent members of the Board, the first Nominating Committee and the first scrutineers should be appointed by the Governor; and
- (b) the new Securities Commission (SC) should ensure that the Board satisfies the conditions to be laid down in the Articles that it is broadly based and representative; that the independent members are genuinely independent; and that the Chairman is a fit and proper person to hold office.

MANAGEMENT

6.78. The Board has delegated some of its powers to committees: an Advertising Committee; Disciplinary Committee; Membership Committee; Working Committee on HSI Compilation; Product Development Advisory Committee; and the Floor Practices Advisory Committee for the Hang Seng Index Market. In addition, there are Market Committees for the various contracts traded on the exchange (Agricultural Division, the Indices Division, the Metal Division and the Interest Rates & Currencies Division). Following the October 1987 events, membership of all of the committees was reviewed and reconstituted to reflect the changes to the Board.

6.79. The Market Division Committees, which meet as and when necessary, are charged with the primary responsibility for overseeing the individual markets. The committee responsible for the Hang Seng Index Market (known as the "Indices Committee") can vary the price fluctuation limits in the market and close the market on reaching any limit. It is empowered to refer any undesirable developments to

the Board, with a view to closing the market for a longer period or introducing other measures (Regulations 5035 to 5038).

6.80. The Articles of the Exchange give the Board the power to delegate its functions to a Chief Executive but, beyond this, they are almost silent on the position of Chief Executive. The Rules of the Exchange do not contemplate a Chief Executive at all, rather the Board is given a power to appoint a General Manager under Rule 204. Considerable powers are vested in the General Manager (Rules 205 to 208), including powers to appoint or dismiss employees, to commence investigations and to ensure good order on the trading floor. In addition, with the approval of the Chairman or two Vice-Chairmen, the General Manager may in an emergency suspend trading in any market, declare any day not to be a business day and discipline members.

6.81. In our view, steps should be taken to regularise the peculiar position whereby the Exchange management is headed by a chief executive who has no formal powers under the Articles or the Rules but who is supported by a General Manager who has a whole range of powers⁽²⁸⁾. We therefore recommend that the Articles and Rules of the Exchange should be amended to vest appropriate powers in a chief executive officer. In order to ensure his independence, we further recommend that the SC must be satisfied that the Chief Executive is a fit and proper person to hold office and that his terms of appointment give him appropriate authority and independence.

(28) This is particularly important given that a new chief executive has been selected. At present, the Exchange staff is headed by an 'executive vice chairman'.

6.82. Although we have not reviewed the management of either Exchange in depth, we have the clear impression that in so far as concerns their regulatory duties, the HKFE was better managed than the SEHK. In particular, the surveillance department was more active. Since October 1987, steps have been taken by the present management to strengthen the management and Sub-committee arrangements. The internal well being of the Exchange should be kept under review, however, and in particular we recommend that within the next year the OCS/new SC should conduct an audit of the management and departmental structure and financial position and controls at the HKFE.

MEMBERSHIP

6.83. Members of the HKFE must have three qualifications : they must be full or market members, they must be shareholders and they must be registered dealers; but the categories do not overlap completely : not all shareholders are members and many registered dealers are neither HKFE shareholders nor members.

6.84. As a matter of principle, we believe that it is undesirable for a person to be a HKFE shareholder unless he has a serious intention of trading on the HKFE's markets.

6.85. We are particularly concerned that nearly 50% of the Exchange's shares are held by shareholders who do not trade on the Exchange. Unless they are a member, they are not as a matter of practice, subject to Exchange supervision and have not been supervised by the OCS. However, a firm based in Hong Kong is able to trade in overseas futures if it obtains an HKFE shareholding and this is used as a device to enable such firms to enter

overseas markets. This is highly unsatisfactory since the HKFE does not supervise trading except on its own markets while overseas exchanges tend to rely on supervision by the traders's own exchange, licensing authority and other regulatory bodies. The credibility of Hong Kong's supervisory system will be severely damaged if, as a result of such firms failing or engaging in malpractices in their overseas trading, investors in an overseas exchange suffer serious losses. We believe that firms should only be licensed if they are subject to supervision and that as shareholders of the Futures Exchange, the responsibility should fall primarily on the HKFE. If they cannot be properly supervised, overseas exchanges should be so informed to enable them to form a judgement as regards whether they should be allowed to trade on their exchanges.

6.86. There is a further problem in that such shareholders retain their shareholdings in the HKFE. As with the SEHK, we believe that the Board of the Futures Exchange should be elected by active members and that inactive shareholders should not be allowed to vote. Rather than deprive shareholders of their rights qua shareholders we prefer the OCS/new SC to suspend or, after a period, revoke the licences⁽²⁹⁾ of HKFE shareholders who are not actively trading on the market.

6.87. We recommend therefore that :-

- (a) all shareholders of the HKFE should be required to apply for HKFE membership; if an existing shareholder has his membership application refused, he should be given a period to dispose of his holding;

(29) See Chapter X below on licensing of intermediaries.

(b) that, before authorising a firm, the new SC should be satisfied that it will be properly supervised; and

(c) that inactive dealers should have their registration suspended by the new SC.

Associate members

6.88. During 1987, the Exchange proposed the creation of an associate category because of fears that, with the massive interest in the HSI contract, the growth of the Exchange would be impeded by the physical constraints of the trading floor. Under the proposal, an Associate Member would not be a shareholder and would not have floor trading rights, but would have to trade via a full or market member, perhaps at a reduced commission rate. An Associate Member would be subject to the rules of the Exchange, the Commodities Trading Ordinance and Exchange supervision. In May 1987, the CTC approved the idea. However, following the fall off in activity since October, the proposal has been left in abeyance⁽³⁰⁾.

6.89. Because they do not trade on the floor, the Exchange would not be able effectively to monitor associates' compliance with its rules, and the clearing house would not monitor associates as they would not be clearing members.

6.90. We see no real need for such a class of members on the Exchange. In line with our principle that only persons trading on the HKFE's markets should become members, we

(30) It should be noted that the new management does not want to pursue this approach.

recommend that the proposed class of Associate Members should not be created.

Trade affiliated members

6.91. Rules 326-354 of the Exchange provide for Trade Affiliated Members, a category of membership designed for firms with an interest in the production, marketing, processing or trading of any commodity traded on the Exchange. As at end-1987, there were 32 Trade Affiliated Members; all but one were affiliated with the commodities markets. Most are Japanese.

6.92. These memberships last for 12 months. They do not entitle the holder to become a shareholder or to trade on the floor. Indeed there are no benefits for the member apart from his being able to say he is a member of the HKFE and to enjoy reduced commission rates.

6.93. As most Trade Affiliated Members are affiliated to the commodities contracts, we are not in a position to judge their utility as we have not examined the commodity markets. However, we are sceptical, not least because of the problems experienced with Trade Affiliated Members a few years ago. We therefore recommend that the continuation of Trade Affiliated Membership should be critically reviewed.

CHAPTER VII

THE FUTURES EXCHANGE

RISK MANAGEMENT STRUCTURE

INTRODUCTION

7.1. In Chapter III we stressed that, to restore confidence in Hong Kong's markets, there is a need to assure international investors that there will be no repeat of the Hang Seng Index (HSI) futures market collapse. In Chapter VI we outlined the implications of the collapse of the HSI futures market and made proposals for the constitutional reform of the Hong Kong Futures Exchange (HKFE). In our view the fundamental cause of the HSI contract collapse lay in the inadequacy of the risk management arrangements : had the management of the three institutions involved - the Exchange, the clearing house and the guarantee corporation - been better equipped and more open, the situation might have been ameliorated but it would have required great insight, forethought and energy given the fatal flaws in the tripartite structure.

7.2. In this chapter we consider these flaws and make recommendations to correct the risk management structure. In the chapter which follows, we discuss the details of the trading controls that must be developed within the new framework. It will be helpful however to make two basic points at this stage. The first is that the system of margining, daily settlement and clearing house surveillance of members is the bedrock upon which a well founded futures market must be based. The second is that the first line of protection to the market is provided not by the resources

backing the guarantee but by the efficiency of the risk management system.

BACKGROUND

7.3. The risk management arrangements in the Hong Kong futures market are complex. Under Section 13(3)(b) of the Commodities Trading Ordinance, the HKFE is obliged to use a clearing house and a guarantee corporation approved by the Commodities Trading Commission. Although strictly speaking it did not need to, the HKFE has used this provision to delegate - or contract out - the clearing and guarantee functions for its markets to two separate bodies : ICCH(Hong Kong) Limited (ICCH(HK)) and the Hong Kong Futures Guarantee Corporation Limited (FGC). As a result, there are three independent bodies with a hand in risk management - the HKFE which runs the market, the FGC which guarantees trades and a clearing house (ICCH(HK)) which provides clearing services and manages the affairs of the FGC.

The Exchange

7.4. The income of the HKFE comes from rebates from the clearing fees paid to ICCH(HK) in respect of each contract traded on the Exchange, membership subscriptions, trading rights subscriptions, and interest on deposits. As volumes rise, the Exchange receives a higher percentage of the clearing fee. In 1986, clearing rebates accounted for around two-thirds of income; and in 1987, when volumes were high, for around 90%. Since it is not directly at risk from the failure of brokers or defaulting clients, the Exchange does not have an immediate incentive to play a day-to-day role in ensuring the financial integrity and stability of the market.

The clearing house

7.5. The ICCH⁽¹⁾ group involvement with Hong Kong dates back to the 1970s when it became the clearing house for the original Hong Kong Commodities Exchange. The contract to clear HKFE trades is held by ICCH(HK) whose income comes from a registration fee on all trades and interest on deposits. It currently has around 35 staff.

7.6. ICCH(HK) does not assume any financial exposure as part of its clearing role. It should be noted, however, that the UK group holding company is a 20% shareholder of the FGC.

7.7. Those members of the HKFE with access to the clearing house and the right to clear trades are commonly referred to as members of the clearing house. However, they are not members by virtue of being shareholders of ICCH(HK). They have no rights in respect of the management and control of the company. In fact each firm is a member only in the sense that it completes an individual application form and signs a copy of the General Rules as to Membership. These give the clearing house the power to call on the member to place margins with the FGC, to call for regular financial statements, to inspect a member's books and suspend or terminate membership. Members agree to honour trading limits and abide by the rules.

(1) ICCH stands for "International Commodities Clearing House". ICCH London has been owned by six leading UK bankers after its erstwhile parent United Dominion Trust got into difficulties in 1974. ICCH London owns International Commodities Clearing House (Hong Kong) Ltd. which employs the local staff and in turn owns ICCH(Hong Kong) Ltd. This latter company, referred to here as ICCH(HK), operates the clearing house under contract and uses the staff of its otherwise non-operative parent under secondment arrangements.

The guarantee corporation

7.8. The guarantee is provided by the FGC. It is a limited company owned by the ICCH London and Hongkong and Shanghai Banking Corporation who each holds 20%; Chartered Capital Corporation Ltd. and Chase Manhattan Overseas Banking Corporation Ltd. who each holds 15%; Wing On Bank Ltd. (ultimately owned by the Hongkong and Shanghai Banking Corporation), Credit Lyonnais interests and Barclays Bank PLC who each holds 10%.

7.9. The FGC is managed under contract by the ICCH(HK). While the policy of the FGC is determined by its board of directors it has no staff and premises of its own. Its current chairman is also chairman of the ICCH(HK).

7.10. The FGC was formed with a capital of \$15 million (US\$1.92 million); having some retained profits its current net worth is \$22.5 million. There were moves before the crash to increase this figure but nothing had been done when 19 October came. As a result of the rescue package, described in detail in Appendix 1, the FGC retains its net worth of \$22.5 million. The recoveries arising from the HSI crash are handled by the FGC as agent for the participants in the rescue package, its own funds are not affected.

7.11. The FGC earns its income by investing the margin moneys placed with it. In addition its bank shareholders are mostly settlement banks under the Direct Margin Debit System and depository banks for the FGC; this is also a potential source of profit for them.

Legal relationships between the parties

7.12. The relationship between the three bodies is governed primarily by two documents: a Deed of Appointment dated 1 December 1985 between the ICCH(HK) and the Exchange Company; and an Appointment and Management Agreement dated 15 November 1985 between the ICCH(HK) and the FGC.

7.13. The Deed of Appointment expires on 30 November 1990. Under it the Exchange appoints the ICCH(HK) :-

- (a) to act as the clearing house;
- (b) to establish and manage a guarantee corporation;
- (c) to provide price reporting services; and
- (d) to promote and develop the Exchange's business.

A central feature of the agreement therefore is that ICCH(HK) was charged with procuring a guarantee and arranging that it should manage the affairs of the FGC. In consequence, a direct relationship between the Exchange and the FGC is not contemplated or provided for.

7.14. The Deed also provides that, either jointly or severally, the ICCH(HK) and the FGC have the power to make rules and regulations⁽²⁾. These rules and regulations

(2) The ICCH(HK) and the FGC have jointly issued General Regulations for Future Delivery Business and a Procedural Manual. Under the Agreement between them, the Guarantor must approve any amendments. It is not wholly clear whether the manual constitutes rules and regulations within the meaning of the General Rules as to membership and, thus, whether a member is bound to comply with the provisions of the Manual.

must pay due and proper regard to the obligations, interests, rules and regulations of the Exchange; and, further, the ICCH(HK) and/or the FGC⁽³⁾ must consult the Exchange before amending their rules and regulations. Converse provisions apply to the Exchange's rules and regulations.

7.15. The Deed gives the Exchange the right to require certain information from the ICCH(HK) on a confidential basis but does not give reciprocal rights to the clearing house to require information from the Exchange.

7.16. Under the Appointment and Management Agreement, which lasts until November 1990 with 12 months' notice from either side required thereafter, the ICCH(HK) appointed the FGC to act as guarantee corporation to the Exchange; and the FGC appointed the ICCH(HK) to manage its affairs.

7.17. Under the terms of the Appointment, the Guarantor may direct the ICCH(HK) with respect to, inter alia, the admission or expulsion of members, margin levels, and the acceptability of bank guarantees in lieu of cash margins. However, so far as we can see, there is no undertaking to provide the FGC with information and the FGC has no power to call for information. Furthermore, the FGC has no powers to require data from the Exchange or from clearing members or to appoint inspectors to investigate a clearing member. It was expected to rely on its manager, ICCH(HK).

7.18. Summarising the formal position of the three parties :-

(3) A curious feature of the Deed is that it purports to cover the powers and rights of the Guarantor but the FGC is not a party to it.

- (a) the HKFE sets the entry requirements for members, undertakes supervision including surveillance of the market on the basis of monthly and quarterly statistical returns, sets minimum margin for brokers to levy on clients and monitors floor trading;
- (b) the ICCH(HK) operates the clearing - matching trades, calculating and settling daily pays and collects - it also runs the affairs of and advises the board of the FGC; and
- (c) the FGC decides on margin calls from clearing members, approves clearing and settlement banks and bears the clearing risks.

7.19. Neither ICCH(HK) nor FGC has any audit or inspection capability of its own. It would appear that they can deal with problems detected in the course of the clearing only by ceasing to clear for the member in question, liquidating his positions or calling for extra margin. In other words they rely on the Exchange to investigate the nature of any problem themselves.

PROBLEMS

7.20. The failures of the past are partly explained by lack of supervisory rigour and the use of too few supervisory tools. As described Chapter VI, improvements are in hand to overcome these problems, but in addition there was a series of design faults which can only be remedied by fundamental action.

Guarantee arrangements

7.21. We believe the guarantee arrangements suffer from the following defects :-

- (a) the guarantee is not direct. There appears to be no direct legal relationship between clearing members and the FGC;
- (b) the mechanics of the guarantee are vague. It is not certain whether the FGC is in fact interposed as counterparty to every trade or whether the FGC simply guarantees contracts⁽⁴⁾. If the FGC does not become a counterparty it might be argued that the FGC is actually guaranteeing the clients of the clearing members;
- (c) the timing of the guarantee is unclear. There is doubt when the guarantee becomes effective; and
- (d) the form of the guarantee is inappropriate. Because the guarantee is currently provided by an outside party, the brokers creating the risks do not carry any on-going responsibility for supporting their market in the event of a collapse. The guarantee, provided through

(4) One of the basic principles adopted by US futures markets is that the clearing house should be interposed as a counterparty to any contract so that once the trade is registered every seller and buyer finds that the clearing house, with its strong financial resources, is the counterparty to the trade.

a limited liability vehicle, had no legal obligation to meet losses over and above the FGC's resources.

7.22. In addition, there are important practical problems arising from the present arrangements. The Government is currently underwriting the integrity of the HSI futures market as the loan facility it provided to the FGC, as part of the October 1987 rescue package, can be rolled over until October 1989. While this has been judged expedient, in our view it is undesirable as anything except a short-term measure, on the grounds that it creates "moral hazard" because counterparty risk is totally eliminated as brokers can trade with impunity. Moreover, in the event of a default, the rescue package facilities can be drawn down by the FGC before they use any of their own resources; and the lenders have no recourse to the FGC. In consequence, the FGC is not itself currently at risk from guaranteeing the HSI futures market which is undesirable given that the whole basis of using an external guarantor is the element of self-interested discipline it should bring to bear.

Institutional arrangements

7.23. The institutional arrangements are also flawed:-

- (a) the HKFE and the FGC do not have a direct legal relationship. Moreover, the Exchange does not appear to be under any obligation to ensure the resources backing the guarantee are adequate;
- (b) the FGC does not have a direct relationship with clearing members. It has to rely entirely on its manager, ICCH(HK);

- (c) the clearing house bears no risk. While ICCH(HK) is responsible for managing the affairs of the FGC and therefore for risk management, it is not exposed to any risk, is remunerated by a levy on volumes, and has a firm contract until late 1990; in other words, it may not have sufficient incentive to act as a tough risk manager as well as a clearing processor;
- (d) ICCH(HK) and FGC are indistinguishable. Having the same chairman and the same lawyers is not conducive to ensuring that the FGC would deal firmly with ICCH(HK) if its risk exposure were not being properly protected; and
- (e) risk management functions are not integrated. Key elements of day-to-day risk management are separated: the Exchange monitors capital levels and is the only body with powers to inspect brokers; ICCH(HK) receives daily information on pays and collects; and the FGC now sets original margin levels for the clearing members⁽⁵⁾.

7.24. The separation of the various aspects of day-to-day risk management mentioned in para. 7.23(e) is particularly important. The ICCH(HK) should be central to

(5) Prior to October 1987 the last task fell to ICCH(HK). While it is clearly right that the risk taker should be responsible for the key risk management decisions, it must reduce the ability of the clearing house to react promptly and flexibly to market developments.

the scheme of things as it receives daily information concerning the pays and collects, net open positions, gross open positions and volumes of each of its clearing members. The Exchange's surveillance unit and the ICCH(HK) team should have worked together hand in glove; indeed, with no surveillance capability of their own, ICCH(HK) and the FGC were dependent on the Exchange in this area. But they did not work together, perhaps because the need was not fully appreciated.

7.25. The Exchange did not look out for credit risks either. Before the crash the Exchange had made reasonable efforts to develop a surveillance team⁽⁶⁾ but could not have expected to prevent a major collapse through its analysis of quarterly returns; periodical financial returns are of limited utility given that balance sheets can be expanded or shrunk with ease and that a firm's financial position can be subject to abrupt changes. The Exchange does, however, have an unequivocal interest in ensuring the integrity of its markets. Having contracted out the essential risk management functions, it should have ensured on a continuing basis that the arrangements were adequate.

7.26. It might be argued that, provided it holds sufficient margin to cover a reasonably expected price movement, the ICCH(HK) can sit comfortably. This is true only provided that it can react quickly in fast markets and that firms will be able to withstand the impact of unexpectedly large price movements on house positions and the consequently increased risk of client defaults. Checking that a firm has met today's margin call in respect of yesterday's trading is reactive. The concern should be whether, given a firm's overall financial position, it will be able to meet tomorrow's margin call in respect of

(6) Certainly it was much more advanced than the SEHK.

today's trading. In our view active clearing house monitoring is an essential supplement to margin collection as the clearing house is responsible for spotting credit risk problems on a day-to-day basis.

7.27. During 1987, the ICCH(HK)'s processing resources had to cope with a huge increase in the volume of trades to be cleared. This may have diverted attention away from risk management, beyond checking that daily margins were collected. In any case, even though their job was to safeguard the position of the FGC, the system was constructed in a way which might not have sufficiently emphasised that they had to take the lead on risk management and indeed that in many respects they sat right at the heart of the regulatory system. Whatever the position, the ICCH(HK) did not act to prevent the enormous concentrations of risk in the market⁽⁷⁾. This was partly because they did not see it as their job to look through a clearing member to its clients. But this missed the point that a firm is only as sound as its assets, which in the case of futures brokers are predominantly their claims on clients.

7.28. In our view, the FGC board and its shareholders, taken as a group, did not appreciate the risks involved in their sole business of guaranteeing futures trades. They depended heavily on the ICCH(HK). During the summer of 1987, consideration was given to increasing the share capital of the FGC and generally to strengthening its position. But nothing was actually done, partly because of the lack of flexibility in the current system and perhaps also because the bank shareholders did not have a direct

(7) In October 1987 a few traders in the futures market built up very large open positions; some through dealing companies with nominal capital.

interest in futures market. In any case, discussions centred on increasing the capital in case of a default, rather than strengthening the risk management arrangements to reduce the prospect of a default.

7.29. The FGC and ICCH(HK) have pointed out that they lacked adequate powers. We agree but we believe that all concerned had a responsibility to ensure that the arrangements were adequate to identify risks building up in the system and, if appropriate, to secure greater powers for the risk managers.

7.30. All things considered, we believe the existing arrangements are deeply flawed. At the very least, the following changes need to be made :-

- (a) the mechanics and terms of the guarantee must be unequivocal and easily understood;
- (b) the FGC should have a direct relationship with the Exchange;
- (c) the FGC should have a power to call for information directly from clearing members;
- (d) the ICCH(HK) and FGC should have a power to call for information from the Exchange;
- (e) the ICCH(HK) must act as a risk manager first and a processor second;
- (f) the Exchange and ICCH(HK) must work together closely to monitor markets; and

(g) the regulatory authority must supervise the clearing house and the guarantee corporation so as to ensure the system is adequate.

7.31. Some improvements have already been made; we have been assured, for example, that the Exchange and the clearing house are working together. However, we are convinced that tampering with the existing system will not secure sufficient improvements. In our view, the guarantee and institutional arrangements need to change and, in particular, clearing members should be made collectively responsible for the integrity of the market and the Exchange should have a stronger hand in risk management.

PROPOSALS

Institutional structure

7.32. With the best will in the world, we do not believe a tripartite system is workable. It is essential in our view that the clearing house should have full discretion to apply its risk management tools and that, in particular, it should not need to refer to another body, the guarantor. Or put another way, we believe the clearing house should be the guarantor and manage its own risks and, as explained in para. 7.52 below, we believe that the clearing members of the Exchange should stand behind the clearing house and should therefore be represented on its governing body.

7.33. The guarantee arrangements we recommend would reduce the number of bodies from three to two - the Exchange and a clearing house : the question is whether or not the clearing house should be part of the Exchange.

7.34. If the clearing house were to become part of the Exchange, a Clearing Division would be established, headed by a Clearing Manager and under the control of a Clearing Division Committee(8).

7.35. If the clearing house were to be outside the Exchange, we believe a dedicated clearing house would need to be established - the "Hong Kong Futures Clearing Corporation" - which would be the Exchange's Siamese twin(9). This could be a statutory corporation and would not need to have any shareholders.

7.36. The choice is between integration and independence. An in-house clearing function is defended on the grounds that this is the best way of ensuring that the Exchange's surveillance area works closely with the clearing house's risk managers. A separate clearing house is said to be necessary to ensure its independence and, in particular, that the risk manager has an appropriately free hand.

7.37. Independence could, however, be forfeited under either structure. If the clearing house was part of the Exchange, any clearing member representative on the clearing house committee would obviously have a conflict of interest and might be tempted to use the soft pedal. But equally, clearing member representatives on the board of a separately incorporated clearing house would be in the same position. In either case, it is the professionalism and

(8) This is roughly the system used by the Chicago Mercantile Exchange (CME).

(9) This is roughly the position of the Chicago Board of Trade and the Chicago Board of Trade Clearing Corporation.

independence of the staff and the presence of an independent view (from outside members) which is critical. The problem of independence is not something peculiar to futures markets or clearing corporations - it is precisely the main concern with the Stock Exchange of Hong Kong and with self-regulatory organisations generally.

7.38. We believe that either route would work. On balance, however, we recommend that the clearing house should be incorporated as a wholly-owned subsidiary of the Exchange. Its Board should include the Exchange Chairman and Chief Executive, the clearing house manager and representatives of those backing the risks of the clearing house. There should be a strong independent element. The clearing house should operate as a division of the Exchange so as to secure minute-by-minute co-operation between the clearing house and the Exchange surveillance department.

Management of the clearing house

7.39. We believe it is important to develop professional futures market risk managers in Hong Kong. In this respect, we note that the Exchange has already taken a leading role in developing improvements for the clearing system.

7.40. We therefore recommend that from the outset the senior full-time management of the clearing house should be employees of the Exchange (or the Clearing Corporation, if appropriate) and not contracted in from outside. Given that other senior members of the Exchange staff will need to place considerable emphasis on building up volumes and introducing new contracts, we recommend that the clearing house manager should have high rank within the Exchange organisation.

The guarantee

7.41. We believe that the market's integrity should be underpinned in the first instance by the clearing house substituting itself as a counterparty to every trade that is registered with it and thereby assuming the rights and obligations of a seller or a buyer (as appropriate); in other words, clearing members would not be guaranteed as such but would have a robust central counterparty⁽¹⁰⁾. We therefore recommend that the clearing house should be a counterparty to every trade.

7.42. It should be made clear in any documentation that the clearing house guarantee extends only to its clearing members, i.e. those parties to whom the clearing house becomes a counterparty; there should be no question of the clearing house protecting a clearing member against non-clearing members or its clients.

7.43. The clearing house needs resources to cover its risks. However assiduously its risk management arrangements are conducted and even with gross margining, clearing members cannot be completely relied upon to collect margin from non-clearing members nor can non-clearing members be relied upon to collect client margins promptly. Similarly, neither clearing members nor non-clearing members can be relied upon to maintain their capital resources at the required levels between monthly reporting dates.

7.44. In any case, the clearing house will need extra resources to protect its risks if the clearing arrangements are brought into line with markets elsewhere so that the

(10) For convenience, we nevertheless refer to this as the clearing house guarantee.

guarantee applies from the point at which trades are matched, typically during the evening of the trading day and so before margin is posted the following morning. This overnight exposure of the clearing house can be quite considerable but, provided the clearing house properly covers its risks, should further strengthen the market as it reduces broker-broker counterparty exposure much earlier.

7.45. We therefore recommend that the clearing house should cover or lay off its risk so that it is not significantly exposed itself and should only accept risks to the extent that it has resources available to cover them.

7.46. The clearing house could look outside the system for capital or it could rely on a clearing members' fund. An argument typically used in favour of an external guarantee is that it transmits counterparty losses out of the futures market to a part of the financial system which is not affected, such as the banking or insurance market. Conversely, clearing members' fund systems are criticised for leaving the risks in the market, which in the event of a crash could exacerbate an already desperate situation. Although this consideration weighed heavily in London some years ago and is still advanced by some, we do not rate it highly. First, so far as the banking industry is concerned, banks are no longer insulated from the securities industry; in the event of a crash, the banks will in any case be incurring losses through their securities operations and subsidiaries. Second, we believe the mutual characteristics of a fund encourage prudence amongst clearing members and, moreover, give them a strong incentive to police the adequacy of the clearing house's risk controls and monitoring procedures. If a sound broker

is required to make a large contribution because of risks elsewhere in the system, it will be in his interests to ensure that remedial action is taken, e.g. barring a weak member from trading or increasing its capital requirement.

7.47. It might be argued that the market should be left entirely free to decide what, if any, resources should back the clearing house guarantee and, in particular, that it should not be for regulators to dictate that there must be a members' fund. In other words, if the broking community refuses to put up a reserve fund but the banks are prepared to continue to provide a guarantee, then the market should continue. Although this view was given considerable weight, particularly given Hong Kong's laissez-faire outlook, we do not agree. A system based on an external guarantee has been tried in Hong Kong and it failed. If futures traders want a market they should back it. If not, then it is not for the Government to sponsor or subsidise the market.

7.48. We therefore recommend that, to ensure that the risk creators take collective responsibility for the integrity of their market, part of the clearing house's risk should be backed by a fund made up of deposits from clearing members (both General Clearing Members and Individual Clearing Members).

7.49. However, in order to bring in external discipline and to increase the clearing house's ability to shoulder risk and so to countenance higher volumes and open interest, we recommend that the clearing house should endeavour to lay off some risk externally - either via a guarantee from a banking syndicate or insurance or both.

7.50. We believe it is likely that the external guarantors would not accept unlimited liability - that is

to say, they would put a ceiling on any guarantee/insurance they provided. Above and beyond this, the clearing house would have to fall back on its clearing members. We therefore recommend that the clearing house should adopt a rule whereby it can call for extra deposits from clearing members in the event of the fund and any external guarantee being exhausted(11).

7.51. In summary, we propose that, in the event of a default, the clearing house's exposure should be covered as follows :-

- (a) defaulting firm's margin moneys held by the clearing house;
- (b) defaulting firm's Reserve Fund deposit;
- (c) Members' Fund (composing other firms' deposits);
- (d) an optional banking syndicate guarantee;
- (e) optional insurance; and
- (f) calls for further deposits from members(12).

7.52. In view of the foregoing, we recommend that representatives of the clearing members and any providers of a guarantee should sit on the board of the clearing house.

(11) This would be equivalent to the so-called "down to the last drop" rule of the CME - Rule 802.

(12) The offending firm's capital would be a source of repayment for items (c) to (f).

7.53. Finally, we strongly recommend that early steps should be taken to introduce new guarantee arrangements so that the risks entailed in the Government assuming the credit risks in the HSI futures market are removed.

Summary

7.54. We are conscious that we are making our proposals against a background of complicated negotiations amongst the various parties to the HSI rescue package. It is not for us to comment on these discussions but we should record that we strongly believe an attempt should be made to develop a solution for the market as a whole, not least because of the need for the clearing house and its backers to diversify their risks. It could also do something to restore confidence in the HSI futures market. We recommend that the installation of the fundamental reforms proposed in this chapter - the new structure and the new form of guarantee - should be preconditions for the continuation of the HKFE after the present temporary arrangements expire in October 1989.

CHAPTER VIII

THE FUTURES EXCHANGE

TRADING CONTROLS AND SURVEILLANCE

Introduction

8.1. In Chapters VI and VII we recommended constitutional and structural reforms for the futures market. Of equal importance are the trading controls actually applied, which should be designed to ensure that the system as a whole is robust.

8.2. Trading controls can be examined under five headings: tiered market structure; financial requirements; prudential supervision; trading floor conduct; and market surveillance. The new management at the Hong Kong Futures Exchange (HKFE) has already taken a number of important initiatives in this area - see Appendix 24. We should state here that, in the majority of cases, we unequivocally support the reforms and believe they go a long way towards providing the basis for a well-regulated market. However, as set out in Chapter VII, we believe that the new arrangements would stand a much better chance of being efficiently and effectively implemented if the clearing house (CH) became part of the Exchange, with its risks backed (in part) by a clearing members' fund. In addition, we expressed doubts about the implementation of some of the reforms (in particular, the introduction of a tiered market) and would like to see some enhancements or further review in some areas. However, we should stress that an order of priorities will need to be set by the Exchange and the regulatory authorities in the light of developing market conditions.

TIERED MARKET

8.3. Futures markets are generally tiered to ensure that the CH is exposed only to robust clearing member firms which are subject to tighter risk control standards than ordinary members. The benefits are passed down the line: if the CH is sound, clearing members' exposure to each other is (or should be) eliminated; this in turn helps to protect non-clearing members (NCMs), and so on.

8.4. Some submissions have, however, expressed scepticism about whether a tiered market is really needed. We believe that in Hong Kong, where there is a preponderance of small firms and a strong retail speculative interest, the clearing house would be in a better position to monitor and control its risks if it had a limited number of clearing member firms to supervise directly; and if a core of sound general clearing members (GCMs) were responsible for monitoring the non-clearing members whose trades they expressly and unconditionally guarantee.

8.5. While the number of GCMs should preferably be small, the number must not be so small that the CH's counterparty risks are not adequately spread. This is aided by allowing individual clearing members (ICMs) as well as GCMs.

8.6. We therefore support a tiered market structure which has been advocated by the HKFE, and stress the importance of a proper balance between GCMs, ICMs and NCMs (including locals)⁽¹⁾.

8.7. The clearing house, ICCH(HK), which is responsible for the admission of clearing members, has recently taken

(1) Locals may only trade for their own account.

steps towards developing a tiered market. The structure of the market before and after the reforms is as follows :-

<u>Category</u>	<u>Number</u>		<u>Entry capital</u> (\$m)	
	<u>Old</u>	<u>New</u>	<u>Old</u>	<u>New</u>
GCM	2(2)	7	5	25
ICM	90	40	2	10
NCM	0	?	2 or 1(3)	5
Locals	n/a	2	n/a	0.5

8.8. The new market structure does not appear to achieve sufficient tiering. With seven GCMs, less than 40 ICMs and around 50-60 currently active Hang Seng Index (HSI) market participants, hardly any brokers are NCMs. So far this represents a modest advance over the pre-October position, when everyone cleared their own trades.

8.9. While it would not be appropriate for us to recommend fixed limits, as the Exchange and the clearing house must have flexibility to respond to the changing size and complexion of the market, we should put on record our

(2) In practice GCMs, although qualified to clear for other members, did not do so since every member was a clearing member.

(3) Depending on whether Full or Market Member of the Exchange.

concern that, as yet, insufficient progress has been made towards establishing a genuinely tiered market. In particular, there seem to be too many ICMS. In our view the structure of the market must be tailored to ensure that it is robust and that the clearing house is well protected by setting standards that ensure that those admitted as clearing members are of impeccable standing; other members should become NCMs.

8.10. It has also been proposed that Exchange members should be permitted to form associations or co-operatives which could be granted collective GCM status. This is highly unsatisfactory, in our view, because an ineffective GCM could undermine the whole system. It is imperative that a GCM should have a strong risk management capability in addition to an appropriate level of capital and we do not believe that a co-operative of members would have sufficiently robust and independent management.

8.11. In summary we recommend :-

- (a) that the current balance between GCMS, ICMS and NCMs on the HKFE should be reviewed;
- (b) that great stress should be placed on the quality of clearing members - both financial and operational; in particular there should be no dilution of standards in an attempt to achieve a balanced tiered market. The market must be as big or small as the number and quality of the GCMS permit; and
- (c) that co-operative GCMS should not be allowed.

FINANCIAL REQUIREMENTS

8.12. The various financial disciplines that are typically imposed on futures market traders to ensure market integrity and protect clients include segregation of clients' moneys; margins and daily settlement; capital levels and the clearing house's resources. We first provide some background before reviewing areas where we believe additional work is needed.

Background

Segregation

8.13. The segregation of clients' money and property from that of the broker is essential to insulate clients from a broker's house account risk exposure.

Margins and daily settlement

8.14. Margining and daily settlement lie at the very heart of a futures market risk management system. The margin put up by a client with his broker, by a NCM or local with his clearing member and by a clearing member with the CH constitute security or collateral. Each clearing member's position with the CH is marked-to-market at the close of business each day. Taken together with the effect of positions opened and closed during the day, this determines the settlement (pay or collect) made to the CH the next morning before the market opens. If the CH does not receive the moneys owed, it has a right to close out the clearing member's positions when the market opens. By contrast, clients generally do not settle with their brokers every day, although their positions should be

marked-to-market each night. In addition, customers usually make margin payments by cheques which take a few days to clear.

8.15. The appropriate margin level depends primarily on past and prospective price volatilities, the creditworthiness of brokers and clients, and most critically the method and period for settlement. In most markets, the clearing house and the Exchange set separate margin requirements: the CH for its clearing members and the Exchange for brokers' clients.

8.16. In setting a margin level, the CH takes account of the capital adequacy and, more generally, the financial and operational position of its clearing members; and its ability to monitor their positions on a day-to-day basis. Given these checks and controls, and in particular the discipline of the daily settlement system, CH original margin levels are generally designed to cover one day's expected price movement (plus an allowance for execution delays and risks if a defaulted position needs to be closed out).

8.17. While a broker should know his client, he is not able to undertake the sort of day-to-day monitoring which the CH can apply to its members. In addition, a broker's clients will generally be less creditworthy than the CH's clearing members. Exchange margins, therefore, tend to be higher than CH margins. Moreover, brokers have a discretion to require higher margin deposits from their less robust customers. The usual practice is for the Exchange to set initial margins and a lower maintenance margin. If a customer's account falls below the maintenance margin level, the broker must call for more margin.

8.18. Daily settlement with the CH depends on the ability of the CH to obtain (or remit) funds promptly each morning. To this end, most major futures markets operate a bank-based direct debit system.

8.19. Each clearing member has to designate a settlement bank and open a number of accounts with it. The CH informs the banks every morning what they owe/are owed in respect of each client. Before the market opens, the banks must either credit the CH's account or confirm whether or not it will be credited if the broker owes the CH, before the market opens, so that the CH knows whether a firm's position is covered. If not, the CH will consider liquidating the relevant contracts.

8.20. Settlement banks must be of undoubted quality and the CH must therefore do regular credit assessments. Moreover, the banks must understand the business and know their respective clearing members well. They must also be prepared to be tough and say "no" if a member is in difficulties.

8.21. In fast markets, clearing houses (and brokers) will make intra-day margin calls, to reduce their overnight exposure. The Chicago Board of Trade Clearing Corporation, for example, goes further. It makes one intra-day margin call as a matter of routine.

Capital

8.22. Although a firm holds cash collateral (i.e. margin) against risk exposure from its clients, it still needs a prudent level of capital resources.

8.23. GCMS need to be particularly well capitalised because they guarantee to the CH that their non-clearing member clients will perform; ICMS also need to be subject to fairly tough capital requirements because the CH is exposed directly to them; whereas locals need less capital as the public is not exposed to them.

8.24. The basic capital requirements constitute an entry cost which ideally should rule out the "fly-by-nights".

8.25. Additionally, capital is required to cover the firm against the possibility of client defaults. While the margin deposit is designed to cover this exposure, it may not be sufficient to cover the losses. The firm must therefore have some resources to guard against a reasonable degree of loss through client defaults.

8.26. In addition, a firm which trades for its own account needs capital to cover its position risk. If the market moves against it, the margin it has pledged with the CH or its clearing member cannot be recovered. It is therefore reasonable to require margin payments to be fully covered by capital. Moreover, if it either cannot or does not wish to liquidate its position and crystallise its loss, the firm must put up more margin. In the case of a clearing member, the additional margin must be paid next day. A firm therefore needs to carry surplus capital (or be able to raise more capital at short notice) in order to cover further margin payments.

Clearing house resources

8.27. As explained in Chapter VII, the clearing house which guarantees trades needs to be protected in the event of a major default. Typically it can fall back on its own

resources or a clearing member's fund or an external guarantee. Although a reserve fund is usually presented as a different type of risk management tool, in terms of the immediate cost to clearing members, it is not dissimilar from an additional net margin requirement if contributions are based on the size of open positions.

Issues

8.28. Against this background, we identified a series of issues when reviewing the HKFE's reforms. These were :-

- (a) setting margin requirements;
- (b) reduced margin requirements for hedged positions;
- (c) the effects of the move to gross margining;
- (d) the workings of the daily settlement system;
- (e) the possibility of regular intra-day settlement;
- (f) the adequacy of the risk-based capital requirements;
- (g) position limits; and
- (h) the size of the clearing members' fund.

Original margins

8.29. It is imperative that margin levels should be set in the light of all relevant factors, including past and prospective future price volatility and the particular characteristics of the Hong Kong market. In addition, great care must be taken if anything other than cash is accepted as collateral. We therefore recommend that : -

- (a) in view of the default risk in Hong Kong, it may be appropriate for the HKFE and the CH to use a high confidence factor in setting margin levels⁽⁴⁾; and
- (b) the clearing house should apply appropriate haircuts if it allows securities or other traded items to be deposited in fulfillment of margin requirements; if it allows bank letters of credit to be posted, it must restrict these to the soundest banks and must keep the creditworthiness of those banks under review.

Hedged position margins

8.30. Some exchanges set lower margin requirements for hedged positions on the grounds that the customer's exposure is reduced. It was suggested that the HKFE should follow suit. There is a case for this on the ground that it is important to encourage hedgers to use the market, and moreover that a hedged position is less risky. However,

(4) Confidence factor: the predictability that the margin will be adequate.

we doubt the advisability of such a concession being given by the HKFE at the present time because of the difficulty of ensuring that the hedge is in place and remains in place. Furthermore, in the absence of unified clearing arrangements, the HKFE cannot be certain that a customer will be assisted in meeting a futures market margin call by virtue of an appreciated cash market position.

8.31. It is important to take a very strict view with regard to the risks taken by the CH, as it is the bedrock of the system. Since it does not have access to the hedge instruments and cannot therefore be certain of covering a default, we strongly recommend that hedge-position concessions should not be introduced by the clearing house.

Gross margining

8.32. Gross margining is comparatively rare. So far as we know, it is used only by the Chicago Mercantile Exchange and New York Mercantile Exchange amongst the major exchanges. Under a net margining system, a clearing member with one client long 100 contracts and one client short 99 contracts, has to put up only one unit of margin with the CH. Under a gross system, it has to put up 199 units. The effect is that a clearing member has to place customer margin moneys with the CH which he would otherwise hold himself.

8.33. A switch to gross margining, moreover, alters the quantum and direction of cash flows within the system. This alters the distribution of risk between clients, brokers and the CH and the extent and timing of risk transfer. Given these differences, it is necessary to review the merits and demerits of a gross margining system. The main advantages are :-

(a) gross margining should enhance the security of the system as a whole by increasing the incentive for brokers to collect margin from their clients; if they do not, they have to carry the cost of placing margin with the CH which can be a lot more expensive under a gross margining system⁽⁵⁾;

(b) the CH in particular can be better - possibly much better - protected against price swings. Under a gross system it can withstand a higher price shift for the same level of default. In other words, the effective rate of margin for the CH is increased;

(c) in the event of a default, the CH may find it easier to transfer individual client positions to another broker as the whole of the relevant margin can be transferred at the same time; and

(d) as customer margins are with the CH, gross margining protects customers against the risk of theft by their broker⁽⁶⁾.

(5) In Hong Kong's case, however, the effect in the months leading up to October 1987 might not have been that great; anecdotal evidence suggests that most brokers had positions (house and client) predominantly on one side of the market.

(6) A November 1986 study by the US National Futures Association showed this was historically the most frequent cause of insolvency losses in the US.

8.34. We strongly support the move to a gross margining system, as it helps to ensure that brokers collect margin moneys from their clients, failure to do so was alleged to be one of the major problems in the period leading up to the October crash. We note, however, that if a broker's capital is regarded as primarily protecting his clients from the customer's point of view, a move to gross margining raises the question as to whether capital requirements should be increased.

Direct debit daily settlement system

8.35. In common with many other futures markets, the HKFE operates a direct debiting system with the major banks. Each clearing member has to designate a settlement bank and open three accounts with it (in HK\$, US\$ and Yen). The FGC also has three accounts with each bank. ICCH/FGC inform the banks every morning what they owe/are owed in respect of each client. If the client owes money the banks have an hour to credit the FGC's account or to confirm that it will be credited.

8.36. We have identified two possible concerns with this system :-

- (a) there does not appear to be a written agreement between the FGC and the banks that, once they have confirmed a payment will be made, they are 100% committed; and
- (b) as a matter of practice, the banks have not always been able to confirm one way or the other in the time allowed.

8.37. The first is also a concern in the US, where the Commodities Futures Trading Commission (CFTC) has called for a tightening up. The relationship with the settlement banks must be explicit and irrevocable. In addition, the banks must be of undoubted quality and the CH must therefore do regular credit assessments.

8.38. As to the second concern, while it is perhaps understandable that the banks were not able to respond in time in every case during October 1987, it is in fact more important than ever that they should respond quickly during a market crisis; not least because a smooth-functioning bank-based settlement system is fundamental to the CH's security and to confidence in the system.

8.39. We therefore recommend that : -

- (a) steps must be taken, by the regulatory authority if appropriate, to ensure that the direct debit system is secure; in particular, banks should always confirm that they will (or will not) make a payment before the market opens;
- (b) the settlement banks must be totally committed once they have indicated they will make a payment; to that end, settlement banks should enter into a written agreement with ICCH/FGC which makes it certain that the banks are 100% bound once they have confirmed they will credit an account; and
- (c) the CH should run regular credit checks on its settlement banks.

Intra-day margining

8.40. We believe that, if volumes and risks build up in Hong Kong again, twice daily margining could represent an important enhancement to the system as it could help to relieve pressure on brokers and, more importantly, on the banks who can otherwise be faced with enormous credit decisions and payment obligations first thing in the morning. An afternoon margin call would give all concerned, including the CH and Exchange, more time to identify and rectify potential problems. The rules would need to be carefully prepared, however, to ensure that the CH did not pay away too much to members who had lost money during the day. We therefore recommend that the HKFE and the clearing house should review the case for introducing a regular intra-day settlement if volumes and open positions build up again.

Hong Kong's risk based capital requirements

8.41. We believe that the new minimum capital requirements introduced by the HKFE and the CH are a positive move. However, it is important that a broker's capital should keep pace with any expansion of its business. The key to this is risk-based capital requirements. The HKFE has such requirements under Rules 307 and 321, which provides that members (including all clearing members) must maintain a level of "adjusted net admissible assets" of no less than the greater of :-

(a) \$2.5 million (being 50% of the basic \$5 million share capital requirement), and

(b) 4% of clients' segregated funds.

8.42. Adjusted net admissible assets are defined as "net admissible assets less the relevant margin required on open futures contracts held in the proprietary accounts of the member". That being so, house account position risk is covered to the extent of the authorities' assessment of one day's expected volatility.

8.43. The requirement does not, however, distinguish between GCMs, ICMs, NCMs etc, and the requirement is based on the margin level set by the CH, rather than the higher of the Exchange and CH margins. There is also a case for requiring capital to cover a longer period of risk. Whether or not this is necessary depend in part on minimum margin levels. If margins were set with a 99% confidence level for past volatilities, there would be less of a case for increasing the capital level than if the confidence level were 95%(7).

8.44. As regards client account risk, the main concern is uncollected margin calls. At present, although HKFE members are required to collect margin in respect of client positions and must indicate to clients a specified time for paying margin, there is no formal requirement to hold client funds before opening a position, although we were told that many do so. This is particularly important given the extent of intra-day trading. We recommend that brokers should be obliged to collect a "good faith" deposit from all new customers before they execute trades on their behalf.

8.45. The second element is the 4% capital requirement. This is based on CFTC Rule 1.17 introduced in the late

(7) Very crudely, a 95% confidence level means that the level of margin will cover 95% of all past volatility.

1970s, which has been criticised for not being based on a true assessment of risk: it will be too low if the client has not actually paid sufficient margin and it will be too high if idle funds are kept in a client's account with a broker. It has been proposed by some overseas markets that the requirement should be a set percentage, say 5% or 6%, of a measure of risk, e.g. the relevant maintenance margin requirement or the historical volatility of the contract.

8.46. Even a risk-based requirement looks rather random, however, because 5% of the clients' margin requirement does not necessarily represent the appropriate amount of capital to cover client counterparty credit risk. For example, if the margin rate is 10%, it merely has the effect of providing another 0.5% cover in terms of the nominal value of the contract.

8.47. On balance, we believe that the best way to look at the rule is simply as a crude volume of business requirement: the rule of thumb being that, the more client business a firm undertakes, the more capital it needs. It is difficult, however, to find a good proxy of business volumes for capital adequacy purposes.

8.48. Clients' funds held is one method, as the greater the amount of client business undertaken, the greater the amount of client margin moneys required. An alternative proxy is expenses. For example, capital might be required to be a proportion of annual expenses. An expenses requirement could also be defended on the grounds that a company should be able to withstand running losses for a reasonable period in order that it can wind down its business in an orderly fashion.

8.49. Against this background, we recommend that the HKFE should review its risk-based capital requirements in

the light of debates elsewhere and the nature of the Hong Kong market. In the review, the Exchange should :-

House positions

- (a) consider increasing the requirement on house positions for NCMs (perhaps to 150% of the appropriate Exchange margin level - in line with US/UK practice);
- (b) examine the case for basing the requirement for NCMs on the higher of the Exchange and CH margins;
- (c) consider increasing the margin level so that it covers more than one-day's estimated price volatility, given that further margin calls will need to be backed by capital;

Client positions

- (d) consider whether the "4% of clients' segregated funds" requirement should be revised in the light of the arguments about its adequacy;
- (e) consider requiring brokers to hold adjusted net capital of a higher proportion of segregated customer funds;

Overall

- (f) consider introducing an expenses-related capital requirement; and

(g) consider combining some or all of these approaches.

8.50. In determining capital levels, the authorities should bear in mind that while the move to gross margining should strengthen the system overall, a client may be more exposed in the event of his broker failing through the default of another client, because his margin moneys have been passed to the clearing house. It should be stressed, however, that capital requirements are a matter of judgement and should vary from firm to firm depending on the nature and scale of their business and, in particular, their customer base and internal risk controls.

Position limits

8.51. We strongly support the introduction of net worth-based position limits given that the scale of the problems experienced in Hong Kong in October 1987 can in part be laid at the door of the excessive risk concentrations of some brokers. By introducing limits on net open positions, the HKFE and ICCH have taken a major step forward.

8.52. However, we are concerned that the limit may not be soundly based as it is expressed in terms of a broker's net open position (by number of contracts). While the size of the CH's exposure to any clearing member is that member's net open position, the chance of the risk crystallising depends on the overall performance of the clearing member's clients on the losing side of the market. If one side of the market is crushed by a price shift, the clearing member's ability to meet its obligations to the CH is not increased by the enhanced prosperity of those on the winning side of the market. We

therefore recommend that the HKFE and its clearing house should set limits on gross open positions on either side of the market in relation to net worth, not on net open positions relative to net worth.

8.53. In addition, a broker may have a concentrated exposure not just in respect of position risk but also in respect of counterparty risk. The HKFE and ICCH have not proposed limits addressing this although the Exchange has of course introduced a large open position reporting system.

Members' fund

8.54. In Chapter VII, we firmly recommended that, in future, the CH guarantee underpinning the market should be backed by a clearing members' fund comprising deposits from clearing members.

8.55. It has been proposed that the fund's size should be determined by the level of net open interest at any time; and that, to achieve equity, a clearing member's contribution should vary according to its net open interest. It was suggested that, on the assumption of a default rate of 50%, a margin rate of 10% and a maximum price fall of 30%, the appropriate size of the fund to cover all losses would be $(30\% - 10\%) \times 50\% = 10\%$.

8.56. A large fund is preferable to higher capital requirements from a firm's point of view because it is tax efficient and should not dilute earnings per share or reduce the return on capital to the same extent. Similarly, a large fund is preferable to increased margins from the CH's point of view because the fund is less

reactive to volatility and will not be subject to the same daily fluctuations. It should, therefore, help to cover completely unexpected events.

8.57. We believe, however, that it is unnecessary to aim to cover a 50% default rate and a 30% price fall. To strike a balance between security and the cost to firms, it would be preferable to rely on the CH's right to make further calls on clearing members if its resources are exhausted.

8.58. Moreover, we would stress that a large reserve fund cannot be regarded as a substitute for adequate risk controls. The primary focus must be on improving risk controls and, in particular, the prompt collection of adequate margins, the maintenance of sufficient capital and the monitoring of members' overall financial position.

8.59. We therefore recommend that : -

- (a) the size of the clearing members' fund should not be designed to cover a catastrophe - e.g. a 50% default and a 30% fall; but should be set in the light of the overall risks in the market but not by a rigid formula; and
- (b) members' contributions should depend on the amount of risk they are creating, subject to a minimum level.

Summary

8.60. To sum up, the inter-relationships between margining, daily settlement, capital and clearing members'

fund requirements are complex. For example, the amount of capital required to cover the risks associated with house account trading is determined by margin levels. The multiple of the margin that should be deducted from capital depends in part on the confidence factor used in setting the margin. Collecting adequate margin from clients protects firms against client counterparty credit risks and to that extent, reduces the amount of capital needed in the business. Original and initial margin levels are kept down by the discipline of daily settlement.

8.61. Similarly, an honest customer is more exposed to the risk of his broker failing through the default of another customer under a gross margining system than under a net margining system; in consequence, other things being equal, brokers need to have more capital for their clients to be equally protected.

8.62. For any given level of total market risk, the CH's exposure depends heavily on the adequacy of margin levels, the effectiveness of the daily settlement system and the adequacy of firms' capital. The CH should be better protected under a gross margining system as it holds more clearing member funds; in consequence, it does not need so large a reserve fund as under a net margining system.

8.63. It should be stressed in conclusion that the requirements must be tailored to the most serious risks in the system. While it is imperative to avoiding killing the market by over-regulation, some of the suggested improvements require urgent attention. In particular the establishment of a members' fund discussed in Chapter VII and para. 8.59 above, and the introduction of adequately tiered clearing arrangement (para. 8.11). Others should be introduced over time but with greater urgency if activity increases.

FIRM SUPERVISION : FINANCIAL

8.64. Financial requirements have little point unless firms are monitored to ensure compliance. It is, therefore, essential that the surveillance of HKFE members should be adequate.

8.65. In appreciation of this, the Exchange is making considerable efforts to strengthen its analysis, audit and inspection capability and, in particular, has strengthened its reporting requirements :-

- (a) capital and balance sheet returns to the Exchange are now required monthly rather than quarterly; and returns will be chased if not received within 14 days of a reporting date; and
- (b) large house and client account positions have to be reported to the Exchange on a daily basis.

8.66. We have nevertheless identified three areas where there might be further improvement :-

- (a) in the large open position reporting system;
- (b) in the CH's contribution to the surveillance risk management programme; and
- (c) in the use of early warning signals.

Large open position reporting

8.67. At present, brokers are required to identify clients with large positions by a number in the first place, although the HKFE has a discretion to ask for details. However, to facilitate surveillance on a market-wide basis and to ensure that large traders do not avoid the reporting requirement by spreading their trades over a number of brokers, we recommend that large traders should be identified by name.

Clearing house surveillance

8.68. As argued in Chapter VII above, futures market surveillance is of necessity a co-operative effort between the Exchange and the CH. Although the intensity of supervision must depend on levels of activity and take account of the position of individual brokers, we recommend that the HKFE and the CH should inter alia : -

- (a) recompute the capital position of firms each day on the basis of the monthly capital return and the daily pays and collects;
- (b) compare the daily pays and collects of each firm against the firm's capital and the recent pattern of pays and collects;
- (c) compare open positions and volumes with the recent trends, watching for a rapid build up;

- (d) approach a firm to find out what is happening if any items are significant or unusual; and
- (e) in fast markets, estimate the impact of various price changes on firms and also on customers with reported large positions.

8.69. Moreover, we should stress that, as new contracts are introduced, the Exchange and the CH must base their assessment on a broker's overall financial performance and position; losses in one market may raise questions about whether positions can be supported in another.

Amber lights

8.70. We have already described the HKFE's existing capital requirements and proposed a review. These are, however, minimum requirements. In our view, firms should keep a cushion of capital above this level. This would enable potential problems to be identified before they develop.

8.71. The approach of many securities supervisors worldwide is to formalise that cushion by introducing a system of "amber lights" which triggers more intensive surveillance. In the US futures industry, firms are obliged to keep a 50% cushion above the 4% capital requirement and must notify their Exchange and the CFTC as soon as they breach this level. In addition, firms must immediately give notification of a depletion of capital of 20% or more (whatever the starting level). We believe Hong Kong should adopt both, notwithstanding that this would effectively increase capital requirements.

8.72. We therefore recommend that futures brokers should be required to notify the regulatory authority (and their Exchange, if any) whenever their capital falls below 150% of the regulatory minimum and if it falls by more than 20% from a previously reported level.

FIRM SUPERVISION: TRADING FLOOR CONDUCT

8.73. In addition to financial soundness, it is important that trading floor behaviour is fair and orderly. In particular, all orders should be offered on the floor as this is the only way of ensuring proper price determination and that customers get a fair deal. Furthermore, there should be greater transparency in prices and order flows. Abuses in this area can include :-

- (a) a firm trading ahead of its clients;
- (b) non-competitive trading - e.g. not offering orders on the floor but reaching an accommodation with another trader;
- (c) crossed orders - i.e when a firm does not offer two clients' matching orders on the floor but crosses them in-house; and
- (d) a firm taking the other side of a client order without offering the deal on the floor.

8.74. The HKFE has rules to cover these. The most significant were introduced on 21 October 1987 while the market was closed :-

Rule 445(c) Floor representatives may not trade for their own account until they have executed all client orders.

Rule 445(d) Floor representatives must not withdraw or withhold orders for the benefit of themselves or other members.

Rule 445(e) A floor representative cannot take an opposite position to a client order without the written consent of the client and the relevant member.

8.75. The abuses described arise from transactions conducted within one market. However, the establishment of other derivative product markets opens up new possibilities: for example, trading in one market before executing a large client's order in the other; or using insider information to trade in the futures market rather than buying/selling the particular stock concerned in the cash market. It has been suggested to us that both have occurred in Hong Kong. We therefore recommend that the regulatory authority, the SEHK and the HKFE should together consider how to identify and combat intermarket frontrunning and other bad practices.

8.76. The key to enforcing the rules against these abuses is the time stamping of orders and executions - i.e. an audit trail. Under the HKFE's Rule 447, members must maintain proper books and records and, in particular, these have to show the time, date and nature of instructions received for the trades executed for clients and the time, date and nature of the member's own trading.

8.77. At the moment the HKFE's surveillance is based on floor officials, audit work and following up cases identified through customer complaints. In the longer run and particularly if volumes increase again, it should aim to introduce a computer-based system.

MARKET SURVEILLANCE

8.78. In addition to monitoring individual firms, the HKFE must monitor market trading patterns and developments, and where necessary impose controls in order to ensure orderly and fair markets.

8.79. This is an essential element of an adequate supervisory regime. Potential problems can sometimes be spotted and prevented simply by identifying unusual trading patterns in the market or abnormal relationships between the cash and derivative markets. The HKFE and the regulatory authority must constantly ask themselves what is going on in the market. To this end, they must watch the trading floor and take a broader view. This means that the Exchange must aim to develop a strong research capability and sufficient technical resources to identify trends or patterns. It also means having a feel for the market.

8.80. The Exchange has not yet introduced what are sometimes called speculative position limits - which are absolute limits on the number of contracts a firm may hold irrespective of its capital. As such, they are not a prudential tool but are designed to guard against disorderly markets. We recommend that the HKFE should consider introducing speculative position limits.

8.81. Another important element of market surveillance and management is the application of price limits. This is discussed in Chapter XIII below.

CHAPTER IX

The COMMISSIONS AND THE OFFICE OF THE COMMISSIONER

INTRODUCTION

9.1. In Chapter III we explained that, notwithstanding recent events, we support a continuation of practitioner-based regulation as a means of getting as near as possible to on-line supervision. However, because of our concern that market-regulation could again develop into insider regulation, we recommended that the Exchanges should run their affairs and regulate their markets under the watchful eye of a single statutory supervisor. In this chapter, we make detailed proposals regarding the form, functions, operations and powers of this watchdog.

THE CURRENT SYSTEM

9.2. Until 1973, the Hong Kong securities industry was not subject to regulation apart from the Companies Ordinance provisions governing prospectuses and the registration of stock exchanges, and the Stamp Ordinance tax on the transfer of shares. In 1973, the Government introduced the Stock Exchange Control Ordinance to prevent the establishment of any exchanges further to the four already in existence. In the following year, legislation was enacted along the lines suggested by the Companies Law Revision Committee's 1971 report on The Protection of Investors. This framework, summarised in Appendix 25, is still in use today.

9.3. The reforms introduced in the period 1974-1976 provided for the first time for the recognition or

licensing of exchanges, the approval of products (or more precisely the marketing of them) and the authorisation and regulation of intermediaries. Implementation was to be achieved through the creation of a multi-tier regulatory structure: the Securities Commission and the Commodities Trading Commission; their executive arm, the Commissioner for Securities and Commodities Trading; an investigating and enforcement arm, the Disciplinary Committees; and the largely self-regulating market bodies, the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Futures Exchange (HKFE). The system was underpinned by the Governor and the Financial Secretary who have powers to give directions.

The Commissions

9.4. The Securities Commission and the Commodities Trading Commission were established in 1974 and 1976 respectively as the fulcrum of the current system. They are appointed by the Governor and have a common chairman. Their members, including the chairman, are part-time.

9.5. The Commissions are responsible for ensuring that the Securities Ordinance and the Commodities Trading Ordinance are applied. To that end, they are vested with "all such powers as may be necessary to enable [them] to carry out [their] functions" and may delegate powers, functions and duties to committees.

9.6. Both Commissions have wide powers in respect of the operation of the Exchanges: the Exchanges' Memoranda, Articles and Rules have to be approved by them. They may direct changes to the rules (but not to the Memorandum or Articles of Association) and may impose their own rules governing the operation of the market (such as listing and

dealing practices etc). In certain circumstances, they can revoke an exchange's authorisation or direct a suspension of trading.

9.7. Both Commissions have limited powers and duties in respect of intermediaries. For example, they set minimum capital requirements and may appoint inspectors. In addition, the Securities Commission has powers under the Protection of Investors Ordinance regarding the marketing of investment arrangements to the Hong Kong public.

9.8. The role envisaged for the two Commissions was therefore two-fold: a direct regulatory function through the enforcement of the provisions of the relevant legislation, and a supervisory function in respect of the activities of the two Exchanges. The two Commissions are also charged with advising the Financial Secretary and were therefore expected to play a role in policy development.

The Disciplinary Committees

9.9. Apart from their direct powers over the Exchanges, either Commission may establish a Disciplinary Committee to investigate any allegation that an Exchange, its governing body or any member of its governing body is guilty of misconduct; in respect of the futures market these provisions cover the clearing house but not the guarantee corporation.

9.10. Disciplinary Committees may impose penalties, including recommending de-authorisation of the Exchange itself, disqualifying members of the governing body from holding office, fining the Exchange and reprimanding the governing body or any of its members. The Stock Exchange, but not the Futures Exchange, nominates two members of the Securities Commission Disciplinary Committees.

The Commissioner

9.11. The Commissioner is the executive arm of the two Commissions. This is made explicit in the Securities Ordinance but not in the Commodities Trading Ordinance. As a practical matter, however, the Commissioner and his staff have always acted as the executive arm of the Commodities Trading Commission.

9.12. In addition, the Commissioner has certain direct powers. For example, he is responsible for registering dealers and advisers, has powers to investigate their business and can revoke or refuse to renew a registration. In the event of an emergency, he is empowered to close the Stock Exchange for up to five days. The equivalent powers in respect of the Futures Exchange are, however, vested in the Governor.

9.13. Therefore, powers are divided between the Commissions and the Commissioner in a rather ad hoc way, which presumably reflects the different concerns at the time the various pieces of legislation were passed. Very crudely, the regulatory framework is based on the Commissions regulating the markets, the Commissioner authorising the intermediaries, the two Exchanges running the marketplace and supervising their members and, in the case of the Stock Exchange, a joint Commission/Exchange Disciplinary Committee investigating allegations of misconduct by the Exchange's management.

PROBLEMS WITH THE CURRENT ARRANGEMENTS

The Commissions

9.14. Notwithstanding their executive and statutory responsibilities, the Commissions have been forced to

delegate their executive functions to the Commissioner's Office (OCS) because they are part-time bodies only. They have no resources available to them other than the OCS whose budgets, staff and priorities are dictated by the Administration. Thus, the Commissions rely on the Commissioner to refer matters to them and have become reactive. The Securities Commission described itself as "a mere adjunct to the system" rather than, as was certainly intended by its architects, the centre of it.

9.15. In reality, the Commissions seem to have become advisory committees, except that when the October crisis came, they were not even asked for their advice: they were not consulted on the closure of the Stock Exchange or the futures market rescue package, almost certainly the greatest crisis in the Hong Kong securities markets since the Commissions were created more than a decade earlier.

9.16. Although relatively few submissions from market practitioners considered the position of the Commissions at length, it was clear that they have a low profile and are not clearly distinguished by the public from the OCS. Many submissions simply called for abolition or major changes.

The Disciplinary Committees

9.17. The two Disciplinary Committees are the forgotten part of the existing structure; they were not mentioned in the submissions to us. We understand that the Commodities Trading Commission Disciplinary Committee has met once (in 1978) and the Securities Commission Disciplinary Committee (SCDC) twice, in 1978 and 1983, in each case in connection with a Committee member's own affairs rather than problems with the Exchange's management. We are not surprised by this. Indeed, we find it difficult to see how the SCDC could ever have been effective in combatting problems at

the SEHK given that two of its five members are nominated by the SEHK.

The Commissioner and his Office

9.18. The OCS has been bogged down by routine vetting of advertisements and listing documents, and processing unit trust authorisation applications. Procedures for the registration of dealers and advisers appear to have been perfunctory, a process of negative vetting rather than positive vetting. Moreover, there has been little supervision after registration: the OCS' surveillance unit receives annual accounts from dealers but no more.

9.19. Since unification, supervision of the SEHK by the OCS has proved difficult. The Office was troubled by the inability or unwillingness of the Exchange to regulate itself properly and, lacking adequate powers to enforce its will, decided to undertake the relevant task itself (e.g. approving listing). This led to duplication of effort. Moreover, the OCS did not devote sufficient resources to planning or policy questions without which it was difficult to adjust operations to changing market conditions. The result was that the OCS became too much of a registry and too little of a watchdog at a time when the reverse was needed.

9.20. The OCS was also described in many submissions from practitioners as insufficiently and inexpertly staffed. We believe that, as a simple proposition, this is true. There was a trail of correspondence requesting additional resources. A letter from the Commissioner in the summer of 1985 following a review of the OCS by the Administration is particularly telling in the light of the

circumstances of our appointment some two and a half years later,

"I have no doubt at all that, unless [changes are made], we will have our own equivalent of Hang Lung and OTB.... We are not fulfilling our role at the moment and we cannot do so.... the overall position, serious as it is, will be even further aggravated by the trading of the Hang Seng Index Futures Contract"(1).

9.21. It is important to stress, however, that the Commissioner and his senior staff were well aware of many of the problems and had, in fact, documented a range of issues which were not being addressed adequately, if at all; functions which were not being properly fulfilled; and necessary improvements which were not being made.

9.22. There have, moreover, been considerable achievements in a number of areas, not least of which are the unification of the four stock exchanges, the introduction of statutory listing rules and the ability to cope with unprecedented levels of corporate finance work during the past couple of years while still tackling some significant issues, such as shell re-activations and "B" shares.

9.23. The heart of the problem in our view is the need to operate within the constraints of a tight budget and civil service practices. The failure of the Administration to meet the Commissioner's calls for more resources illustrates the problem, the more so given the amount raised from the industry through stamp duty (\$1.44 billion

(1) Letter from the Commissioner for Securities and Commodities Trading to the Finance Branch of the Government Secretariat, 19 July 1985. "Hang Lung and OTB" refer to two serious banking failures in Hong Kong.

against an OCS budget of \$13.4 million in 1986/87). As well as limiting staff numbers, this has resulted in the Office lacking the technical resources needed for monitoring markets. For example, it has only two personal computers⁽²⁾, three stock exchange screens and no Reuter's screen.

9.24. Where additional staff had been approved, the lengthy and inflexible civil service recruitment procedures caused considerable delays. This is serious because potential trouble spots need to be monitored immediately, not months later. In addition, the need to respect civil service parities has prevented the OCS from competing in the market for suitably qualified staff.

9.25. Quite apart from resource problems, the lines of command and authority have become unclear. The OCS never really achieved its intended role as the executive arm of the two Commissions. Very often, rather than going to the appropriate Commission for direction, the Commissioner dealt first with the Administration, subsequently looking to the Commission for endorsement.

9.26. To sum up, the regulators did not have the right priorities prior to October 1987 and the current arrangements were (and are) opaque to outsiders and confusing to insiders; there are crossed lines of communication and command with neither the Government nor the Commissions firmly in the driving seat. As part-time bodies, the Commissions cannot properly discharge their statutory duties of overseeing the Exchanges and ensuring investors are protected on a day-to-day basis. As an under-equipped office, the OCS cannot effectively fulfil its functions either.

(2) Both of which were installed since our appointment in November 1987.

9.27. The current structure might have been appropriate when the Securities Commission was established in the mid-1970s as the need then was to inject into the securities industry the standards of integrity which prevailed in other sectors of Hong Kong commercial life, such as the accounting and legal professions. Indeed, it seems clear that the original Advisory Body and the first Commission played an invaluable role. But, in our view, this formula has been rendered obsolete by the massive increase in the complexity of securities markets in recent years (which is by no means a problem peculiar to Hong Kong).

9.28. However, for whatever reasons, the OCS was never adequately provided with the resources to implement and enforce the legislation introduced in the 1970s. In short, the current system lacks structure, direction and resources. Both the Commissions and the Commissioner told us that it is unsatisfactory. It should be changed.

CREATION OF A NEW SECURITIES COMMISSION

9.29. Three basic options for reform were identified for us in the submissions from the two Commissions : -

Option A continue with the current structure but with improvements : a better and larger Office, a full-time Chairman and Deputy Chairman of the Commissions or possibly just a single merged Commission;

Option B abolish the Commissions, leaving the Office in the civil service

with sole responsibility for securities industry regulation; and

Option C consolidate the Commissions and the OCS by creating a new statutory supervisory body outside the civil service headed by full-time regulators.

9.30. We believe the watchdog Commission should be headed by a full-time regulator with relevant experience. He should be supported by a professional staff which in part is made up of career regulators. In this respect, we would distinguish the mindset of the practitioner from that of the supervisor. The transition from poacher to gamekeeper is difficult, not least because it requires a focus on risk rather than profit. It is essential to feel at home with policy issues and the procedures which accompany the exercise of statutory powers. Moreover, the regulator must be tough only when necessary, avoid over-reaction and act flexibly.

9.31. We believe that an effective watchdog cannot be built within the constraints of Government. First and foremost, because of the funding and staffing problems described earlier.

9.32. Second, we believe the job of heading the regulatory body is likely to be of limited attraction to anyone outside the civil service so long as it remains part of Government. This applies even more strongly to the regular staff members who do not have the prestige accruing to a senior public post. It is essential that skilled and experienced professional level staff are recruited, in significant numbers.

9.33. Third, we consider it inefficient for the regulator to be answerable on a day-to-day basis to the Government Secretariat, which is not sufficiently involved with the markets to be expert in this field.

9.34. Furthermore, we believe that this separation from the civil service will enable Government to hold itself in reserve. The current arrangements were intended to achieve this by vesting powers in the two independent Commissions. Unfortunately, this was increasingly undermined by the Commissioner being a civil servant answerable directly to Government.

9.35. For these reasons, we reject the first two options and support the third, particularly as it helps to bring together responsibility for the securities and futures markets. We therefore recommend that a new statutory body should be established to assume the role of the existing three regulatory bodies (the Securities Commission, Commodities Trading Commission and OCS). It should be outside the civil service; and staffed at all levels by full-time professional staff. As the successor to the two Commissions, we believe that the name Securities Commission (SC) is more appropriate.

THE CONSTITUTION AND MANAGEMENT OF THE NEW SC

9.36. We believe the new SC should be created by statute as a non-profit-making organisation charged with supervising and regulating Hong Kong's securities and futures markets and intermediaries to ensure the integrity of markets and the protection of investors.

Governing body

9.37. Given the breadth of its operations, it would be inappropriate to vest the powers and responsibilities in a single person. He would be both too powerful and undesirably stretched, even with the Exchanges undertaking much of the day-to-day supervision.

9.38. We recommend that the new SC should be governed by a small board, preferably with seven members: a chairman, deputy chairman, two other full-time directors and three non-executive directors.

9.39. While carrying full responsibility for the management of the Commission, the four full-time SC board directors should not be too closely involved in detailed day-to-day business, although of necessity they would be close to major issues. They must be free to see the wood for the trees, to manage the agency and its various departments and to steer a course based on a clear set of policies. The day-to-day work would therefore fall to their supporting staff.

9.40. We see a role for non-executive directors on the board to keep the full-time directors on their toes and to bring an independent eye to the SC's management. They should take a primary interest in the areas of management and organisation, rather than policy and operational supervision and would not therefore need securities market experience or expertise. They should not be actively involved in the securities industry.

9.41. Given the considerable commercial sensitivity of the information in the SC, the non-executive directors should not have an automatic right to see sensitive papers on individual cases.

Staffing

9.42. While it is not our job to organise and staff the new SC, we believe some broad guidelines may help the Administration, the market and other readers to understand our proposals.

9.43. The main issue is quality and not quantity. Securing an improvement in Hong Kong's regulatory standards depends on the quality of the professional level staff. The new SC is likely to fail unless its staff are up to the job and are motivated and professional. At the outset, the quality of the policy work will be particularly critical as the new SC will need to develop a workable approach to regulation, which takes account of the nature of the business conducted and the risks entailed, developments in supervisory techniques elsewhere and what is realistically achievable given Hong Kong's particular circumstances and its lack of familiarity with modern supervisory thinking.

9.44. For these reasons, we have recommended that the new SC should be outside the civil service. This will enable it to adopt a flexible recruiting policy. It is important to stress what we mean by this : -

- (a) no strict localisation policy (although the SC would be imprudent if it did not aim to have staff at all levels who are permanent, indigenous Hong Kong residents);
- (b) no civil service benefits, including pensions, housing etc. (the SC would have to make its own arrangements); and
- (c) higher salaries.

9.45. After discussions with current and past regulators in Hong Kong, we are certain that, notwithstanding the higher quality of professional staff to be employed, there must be a substantial increase in the numbers of staff at the new SC over the current establishment of the OCS. Although we are in no position to quantify this increase, we note that locally the Office of the Commissioner of Banking has some 150 professional staff to regulate 400 banks and deposit-taking companies. Internationally, the Bank of England has about 200 staff supervising 600 banks. In the US the Securities and Exchange Commission(SEC) has some 2,000 staff for 11 Self-Regulatory Organisations(SROs) (including ten exchanges), and the Commodities Futures Trading Commission has around 500 staff for 14 SROs (including 13 exchanges).

9.46. We hope that the new SC could be built on those existing OCS staff who are judged to have the appropriate skills and motivation: this does not automatically mean everyone. Transfers may need to be subject to special terms, given the impact of moving outside the civil service, but that is not a matter for this Committee.

9.47. The current OCS staff plus any new recruits should be supplemented by secondees from the private sector (particularly bankers, lawyers and accountants) and overseas regulatory bodies (including from countries other than the UK).

9.48. In addition to people, the SC will need much better technical resources than the OCS has been able to secure. It will also need to avail itself from time to time of outside advice. The consequence of these changes would be a significant increase in the current OCS budget.

Advisory Committee

9.49. It is in our view essential that the SC should have ready access to outside expert advice and securities market practitioners in particular. Although we expect it to consult widely on new developments and significant policy proposals, we believe that some formal machinery should be put in place for this purpose.

9.50. We therefore recommend that an Advisory Committee should be appointed to advise the SC on matters of policy and market development. It should have no executive responsibilities and no statutory powers. It should meet not less than once a month and should receive secretarial support from the SC.

9.51. It will be important to keep the structure as simple as possible to avoid rival power bases and to ensure that the Advisory Committee sees its role as advisory. It is not there to police the SC - that job is for the Administration and, to an extent, the SC's non-executive directors. We accordingly recommend that the Chairman and Deputy Chairman of the new SC should sit on the Advisory Committee as ex officio members and the new SC Chairman should also chair the Advisory Committee.

9.52. As to composition we believe it should be predominantly expert rather than amateur and generalist, with outside members drawn from the various segments of the Hong Kong securities industry, plus a lawyer, an accountant, a representative of a listed company and perhaps someone from outside. But it should not be too big. We therefore recommend that the Advisory Committee should be eight to 12 strong, with six to ten outside members drawn from the securities industry and the professions.

9.53. Given the key role of the new SC as watchdog over the market bodies and to ensure that the watchdog body is entirely independent from the Exchanges, we recommend that representatives of the Exchanges and the clearing houses (whether staff or Council members) should not sit on the new SC board or on its Advisory Committee.

9.54. In any case, representation should be unnecessary as informal machinery can be established to enable the SC, the Exchanges and the clearing houses to work closely together.

RELATIONSHIP BETWEEN THE NEW SC AND THE GOVERNMENT

Accountability to the Administration

9.55. Given its intended significant role in Hong Kong's economic life we are in no doubt that the SC should be accountable to the Administration and furthermore that, while it is not part of the civil service, it should be - and be seen to be - part of the wider Government machinery. We therefore recommend that : -

- (a) the Governor should appoint the Chairman and other directors of the new SC board and should have the power to dismiss all or some of them;
- (b) the Governor should be able to give the new SC directions;
- (c) the new SC should be obliged to present an annual report and statement of account to the Governor who would lay them before the Legislative Council; and

- (d) the new SC's Advisory Committee should be appointed by the new SC with the approval of the Governor.

9.56. Linked to accountability is funding. We believe that the new SC should be funded to a significant degree by the market - indeed, along with a need for greater flexibility in staffing policy, this is one of the main reasons for moving the regulatory function outside the civil service. A Government contribution would however enhance accountability and can in any case be defended on the grounds that the SC will be undertaking a quasi-governmental task. We therefore recommend that the new SC should be funded mainly from the market but partly also from Government.

9.57. The market contribution would be in the form of charges for services and, as such, would fall on dealers and advisers, the Exchanges, the clearing houses, and anyone else that was authorised by or needed approval from the SC, including unit trusts and listed companies (in respect of new issues). The Government contribution could be a fixed amount, a fixed proportion of the budget or a deficiency grant. We prefer the last as it is the most flexible.

9.58. The new SC will need powers to levy charges on the market; to ensure accountability for its ability to tax the market, we recommend that the new SC Chairman should develop and submit its annual budget to the Finance Committee of the Legislative Council.

Day-to-day contact with the Administration

9.59. Matters concerned solely or primarily with securities markets and regulation should in future fall

squarely to the SC. In particular, supervisory rules - such as capital ratios and conduct of business codes - should not need approval from Government; nor should new market contracts.

9.60. More generally, it is essential that Government should not direct the new SC's policy. The SC Chairman, Deputy Chairman and executive directors must be the immediate points of contact for the market; there must be no question of going over their heads to Government. We also believe that it is unlikely that Hong Kong will be able to recruit someone with sufficient stature and experience to head the new SC if he is not reasonably independent.

9.61. While it is important that Government should continue to provide an overview, difficulties will arise if this becomes interference. The dividing line between pure security regulation issues and issues with wider implications is thin, perhaps increasingly so given the integrated nature of modern financial markets. In order to ensure the SC's independence we recommend that all the statutory regulatory powers should lie with the new SC.

9.62. Finally, the Administration should not have its own Advisory Committee on securities industry matters and should not receive the agenda or minutes of the SC's board or Advisory Committee meetings. If the Administration wants advice on securities industry matters, it should turn to the SC.

9.63. To avoid undermining the new SC's independence, the Government should not be represented on its board. If the Administration is to monitor the new SC effectively (i.e. to be the watchdog over the watchdog), it should not play a direct role in day-to-day policy determination. The role of Government should be to ensure that the SC does its

job properly. If the SC fails, the Government must be free to reach an independent view of what is the right course of action in any particular case. Taking the words of William O Douglas, the US SEC chairman in the late 1930s, government "would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope it would never have to be used"(3).

9.64. One of the failings of the existing Hong Kong system has been the lack of distance. In the early morning of 20 October 1987, the SEHK Chairman called the Financial Secretary who was subsequently, rightly or wrongly, presented as having been consulted on the market closure. In future, the Administration should be held in reserve. It will have an opportunity to hear the SC and to take advice. If absolutely necessary it can overrule the SC - if need be by direction but preferably by sheer political authority.

9.65. It is for that reason that we advise against Government representation on the Advisory Committee. Its role is to provide advice, not to make policy; if officials are represented, it will tend to make policy. We also believe that the Committee will work best if it has a purely private sector membership as, in our view, securities industry people are more likely to make a positive contribution if it is clearly their body.

FUNCTIONS AND OPERATIONS OF THE NEW SC

9.66. The broad functions of the SC would be to ensure the integrity of Hong Kong's securities markets and the

(3) William O Douglas, "Democracy and Finance", 1940.

protection of investors. As we see it, its primary functions are : -

(a) to license (where new bodies are concerned), monitor and regulate the management and operation of -

(i) the SEHK and its market;

(ii) any equity clearing house;

(iii) the HKFE and its market;

(iv) any futures clearing house;

(v) any futures guarantee corporation;
and

(vi) any other market bodies (such as the proposed debt market clearing house);

(b) to supervise and audit the regulatory functions of those bodies;

(c) to monitor Hong Kong's securities and derivative product markets (i.e. trading patterns etc);

(d) to license and supervise (directly or indirectly) various categories of securities businesses: securities dealers and advisers; futures dealers and advisers; company registrars;

- (e) to assist the development of voluntary codes of conduct for intermediaries (together with industry bodies);
- (f) to regulate listings under the Securities (Stock Exchange Listing) Rules (until this function is transferred to the SEHK; see Chapter XI below);
- (g) to approve prospectuses to unlisted issues under the Third Schedule of the Companies Ordinance (if pre-vetting continues - see Chapter XI);
- (h) to regulate the marketing of investment arrangements not involving securities - e.g. Commercial Paper etc;
- (i) to approve unit trusts and mutual funds;
- (j) to approve the publicity for life insurance and pooled investment products;
- (k) to administer the Hong Kong Code on Takeovers and Mergers;
- (l) to administer and, where appropriate, enforce all relevant legislation; and
- (m) to develop policies for the above and ideas for legislative improvements.

Policy development

9.67. In order to do its job adequately, the SC should look forward and evolve policies designed to ensure the

continued health of the system. Indeed, if the supervisor is doing his job properly, it is difficult to separate policy from operational supervision, the two feed off each other.

9.68. This should involve a continuing dialogue with the Exchanges and practitioners generally, and also studies of supervisory techniques and developments overseas. As an extension of this, the SC should endeavour to make a material contribution to the growing international debate and the efforts to secure better co-operation and co-ordination amongst securities market regulators worldwide.

Regulatory oversight of Exchanges/clearing houses

9.69. Regulatory oversight of the Exchanges and the clearing houses is the core function of the SC and lies at the heart of our proposals. This entails : -

- (a) reviews of the management structure - finance, staffing etc;
- (b) in the case of clearing houses, an annual intensive review of risk management systems and controls; this must involve identifying and quantifying the risk exposure⁽⁴⁾;
- (c) periodic reviews of the operational areas - dealing, settlement etc;

(4) Both (a) and (b) must be supplemented by the regular independent audit of the Exchange and the clearing house. The new SC should discuss the results of the audit with the accountancy firm and the Exchange/clearing house management.

(d) annual audits of the SEHK's listing division (initially half-yearly); and

(e) annual audits of the Exchanges' surveillance functions. This would involve -

(i) reviews of the rules;

(ii) inspections of the surveillance departments' procedures and records;

(iii) verification examinations of a sample of dealers/traders which had recently been audited by the Exchange; these should be conducted without any notification to the firms concerned or advance warning to the relevant Exchange. The principal purpose of the examinations would be to assess the adequacy of the Exchanges' own surveillance⁽⁵⁾; and

(iv) examining any firms which had been the subject of a serious complaint to the SC where satisfactory action was not being taken by the relevant Exchange.

9.70. The examination of firms should cover their financial position; operational procedures including systems and controls, settlement; customer relation practices; and compliance with rules, regulations and laws.

(5) A 5% sample should be enough; in 1983 Congressional hearings, the SEC said this was their objective regarding head offices.

9.71. As well as ascertaining the substantive position of the firms covered, the SC team must aim to identify problems or rule breaches which were not identified by the Exchanges and, most critically of all, to find out why they were not spotted by the Exchange - i.e. what is wrong with the Exchange's procedures.

9.72. In each case, the SC inspection team should produce a report for its board. The new SC should discuss its findings with the relevant Exchange/clearing house and, where appropriate, formally require changes or improvements.

9.73. The new SC should also endeavour to keep abreast of important market developments and Exchange/clearing house initiatives. To this end, the SC should hold meetings (at least once a quarter) with the Exchange/clearing house management to cover a range of topics. In addition to fulfilling its watchdog function, the SC must develop and maintain a close - but definitely not cosy - working relationship with the Exchanges and clearing houses. We would be disturbed if this did not involve frequent contact at all levels.

Direct supervision

9.74. The SC will have direct supervisory responsibility for securities and futures dealers who are not members of the SEHK or the HKFE. The SC's supervision should be based on the analysis of monthly statistical returns; full-scope annual or bi-annual inspections; surprise audits; and periodic meetings with management. The stress should be on substance rather than form - e.g. the financial position rather than rule violations.

Unit trusts and mutual funds

9.75. At present, the Securities Commission's powers to approve pooled investment schemes are exercised after taking advice from the Committee on Unit Trusts which is chaired by the Commissioner or his deputy. The Committee also administers the Hong Kong Code on Unit Trusts and Mutual Funds.

9.76. This arrangement combines the benefits of practitioner expertise with the objective input of a statutory regulator. We recommend that the new SC should continue with the Committee on Unit Trusts under the chairmanship of one of its executive directors.

9.77. However, we are not convinced that every individual case needs to go before the Committee or the top echelons of the SC. It would be preferable for the SC staff to give approvals on the basis of policy guidelines and criteria developed, laid down and kept under review by the Committee; ideally these might be published. By concentrating on general policy, better use could be made of practitioners' time, helping to mitigate the conflicts of interest inherent in self-regulation and ensuring that policy matters were addressed at the right level. Where necessary, of course, difficult individual cases could be taken to the Committee and/or SC board members.

9.78. The backup provided to the Committee will in any case need considerable improvement, given the enormous unit trust/mutual fund backlog⁽⁶⁾. The processing of applications must obviously be speeded up as it is an impediment to the development of Hong Kong's fund

(6) As at 30 April 1988, there were 148 applications awaiting approval.

management industry and, more critically, brings the OCS into disrepute. It should be stressed, however, that speedier processing need not necessarily entail more approvals.

Life products

9.79. Advertisements for investment-linked life assurance products etc. are currently vetted by a second committee - the Committee on Investment-linked Life Assurance Schemes and Pooled Provident Funds. We believe the new SC should maintain such a Committee, under the chairmanship of one of its executive directors, but that it should concentrate on policy matters; the actual vetting and approval of individual advertisements should be done by SC staff.

9.80. We recommend that at an early stage the new SC should review, with Government and the industry, the objectives for authorising unit trusts and approving life product advertisements, and more generally for the whole area of pooled investment schemes. This should in due course extend to a review of the authorisation and supervision of investment advisors and managers.

Takeovers

9.81. Similar arrangements currently obtain in the takeover area, with the Hong Kong Code on Takeovers and Mergers being administered by the Takeovers Committee, chaired by the Commissioner or his deputy. We envisage this basic structure continuing again with the SC staff playing a greater role in routine matters. In particular, they should offer guidance to financial advisers on the application of the Code and should make preliminary

rulings. In addition, they should keep takeover activity and the Code under review⁽⁷⁾.

9.82. The Committee's role should be to set general policy, to approve changes to the Code and, most critically, to rule on complex or contentious cases. Companies should be able to appeal to the Committee against decisions by the SC staff.

Investment arrangements

9.83. Advertisements for investment arrangements need to be approved by the Securities Commission under the Protection of Investors Ordinance. In the majority of cases, this relates to Commercial Paper and Certificate of Deposit issues, where the Commission acts after taking advice from the Committee on Bills of Exchange and Certificates of Deposit.

9.84. We do not believe that a specialist committee is needed. There is no obvious need for the authorisation of individual issues (or, more precisely, the supporting publicity) given that the same simple rules are always applied. In contrast to unit trusts, life products and takeovers, there is no obvious need for specialist input on a regular basis.

9.85. We accordingly recommend that, after appropriate consultation, the new SC should introduce general regulations setting out the scope of any exemptions in Section 4(2)(g) and conditions in Section 4(7) of the Protection of Investors Ordinance. The permanent staff would implement the regulations, dealing with queries and complex cases and, where necessary, taking advice from its Advisory Committee.

(7) See Chapter XIII para. 13.10.

9.86. As with pooled investment schemes, we recommend that the new SC should review what it should be trying to achieve by regulating investment arrangements.

New issues and listings

9.87. Powers to object to a proposed listing of securities are vested in the OCS (rather than the Securities Commission). Subject to proposals contained in Chapter X below, we can see no reason for the new SC not taking the same approach as there is no need for a special committee in addition to the general Advisory Committee.

9.88. A particularly important role in this area will be the monitoring and assessment of the SEHK's performance as part of its regulatory oversight programme.

The role of joint SC-industry committees

9.89. We have identified the important role which should continue for various committees, such as the Unit Trust Committee and the Life Assurance Products Committee.

9.90. In addition, the new SC could explore the possibility of forming further joint committees with industry bodies which wish to develop a self-regulatory role; for example, any trade associations which promulgate codes of good business practice (see Chapter X below). The joint committee could assist in policy matters and enforcement decisions.

POWERS OF THE NEW SC

9.91. To fulfil its functions, the new SC will need a

(8)
series of powers . In our view these should be vested in the new SC (i.e. the corporation) rather than its governing board, not least because this would avoid having to involve the full board (or a quorum thereof) in each case and would, in time, enable minor powers to be exercised by senior officers not on the board.

Processes and appeals

9.92. It should be stressed that, wherever powers are concerned, there need to be proper procedures in place. We suggest that the new SC should have clear internal rules on what level of staff may exercise what powers; and in particular, that a senior management committee should be established to consider the use of the major powers (revocation of licence, giving directions to an Exchange, etc).

9.93. In addition, the new SC's determinations may need to be subject to appeal, although we would restrict this to really important matters (such as licence revocations) and would prefer that appeals should be on procedures and not on merits.

9.94. Finally, we note that there is at present some doubts as regards whether Commission Committees' decisions are appealable to the Commission. We believe that, in future, all decisions of SC Committees should be reviewable on appeal by the new SC Board.

Powers over the Exchanges

9.95. Most important are the powers the new SC will have to regulate the management and operation of the Exchanges

(8) A list of suggested powers is at Appendix 26.

and clearing houses, and to ensure that they adequately fulfil their self-regulatory responsibilities. For the proposed two-tier regulatory system to be credible, the watchdog has to be able to act swiftly, decisively and, where necessary, with great force if problems develop in the Exchanges or with their members.

9.96. At present, the Commissions and the OCS rely on the "nuclear deterrent" of de-authorising an exchange, which could never be used without damaging the markets. In case problems surface and to persuade the market that the system will work, the new SC should have reserve powers which go less far than the "nuclear deterrent" of de-authorisation. Ideally, these powers would always be held in reserve, but the new SC should not hesitate to use them if this is judged necessary.

Market closures

9.97. An especially contentious issue is market closures (and re-openings). In spite of October's events, we believe that these are fundamentally commercial decisions, or more accurately are decisions which require commercial and market expertise. In this respect, it should be noted that there is still a spectrum of views (held by apparently reasonable people) about whether it was right to close the market. The Administration would be placed in an invidious position if it had to give express consent to a closure as we doubt whether it has - or will have - the expertise to reach an informed, independent judgement.

9.98. We believe it would be better to place the Exchanges under an obligation to give the new SC prior notice of any intention to close (or re-open) a market. We would hope that, if it queried or disagreed with the

proposed action, the new SC or the Administration would be able to use its authority to bring about a pause or reversal. But, if need be, the new SC could fall back on its powers to give directions.

9.99. At present, the Commissioner has the authority, under Section 148 of the Securities Ordinance, to bring proceedings in connection with offences punishable on summary conviction. However, we were told that, as a matter of practice, all prosecutions have in the past been brought by the Attorney General's Chambers. The main disadvantage of this was that the Commissioner's cases have had to compete for priority of treatment with the rest of the Government's prosecution needs. This is unsatisfactory.

Investigations

9.100. We believe it important to distinguish between investigations and prosecutions. Investigations may arise from complaints or from matters identified by the surveillance activities of the Exchanges or the SC. They may not necessarily involve wrongdoing - suspicion of insolvency is as important to securities regulators as suspicion of fraud.

9.101. Initial investigations should be carried out by expert SC staff vested with appropriate powers. Serious cases should, however, lead to the appointment of outside inspectors usually because serious crime would be involved. The general duties of inspectors will include examining papers, documents and accounts and interviewing officers of the companies and others. If the facts of the case merit it, the inspectors may prepare evidence for subsequent prosecution or call for a further more closely focussed investigation.

9.102. Inspection is not a judicial process, although the laws of natural justice apply; it is an investigatory process and inspectors should be guided by the prosecuting authorities as soon as it becomes apparent that there is prima facie evidence of serious crime. We believe Hong Kong should adopt the practice of the UK Department of Trade and Industry and issue notes for the guidance of inspectors.

9.103. Major inspections can involve significant resources which could have serious budgetary implications if the new SC were to bear the cost. They might also absorb the time and attention of senior staff of the SC whose primary concerns should be stability and orderliness in securities markets. It is imperative that the pursuit of serious crime should not be allowed to distract the SC from its paramount role of monitoring and regulating markets.

9.104. We therefore recommend that the direction and funding of major inspections involving serious crime should lie with the Financial Secretary. Inspections concerning non-criminal matters, e.g. solvency, should be directed by the SC.

Prosecutions

9.105. We would distinguish two categories of offence : regulatory offences and serious crimes. By regulatory offences we mean such things as conducting a securities business without a licence, breaching a direction given by the SC, or failing to provide information required under the statute. On the other hand, serious crime includes a variety of frauds and other complex commercial crimes. It involves dishonesty and mala fides. In some cases, of course, a serious crime may involve regulatory offences.

9.106. Another distinction lies between summary offences which can be tried before a magistrate and indictable offences which must be tried in the High Court. All serious crimes will be indictable offences. Most regulatory offences will be dealt with by summary proceedings but a few may be more suitable for indictment as they may raise serious questions of public policy or law.

9.107. The prerogative of deciding whether or not to prosecute a criminal case rests with the Attorney General. However, we recommend that the new SC should be able to bring summary proceedings⁽⁹⁾, provided that the Attorney General will retain the power to take over a case.

9.108. The new SC may occasionally decide to refer a regulatory case for prosecution by indictment because it raises serious issues. In these circumstances, it would obviously look to the Attorney General's Chambers for action.

9.109. The new SC would be required to refer any serious crimes to the Attorney General's Chambers for prosecution. However, the SC has a close interest in the rigorous prosecution of serious crime in the securities industry and should therefore stand ready to help and advise the prosecuting team on technical issues.

9.110. There remains the question of prosecutions in the securities field instigated by the Attorney General on the recommendation of bodies other than the SC, for example the Independent Commission Against Corruption or the Police.

(9) The OCS has such powers under the Securities Ordinance but they have never been used.

We do not think it right to recommend that the Attorney General should have a duty to consult the SC on such matters; to do so would be to fetter his constitutional discretion. However, we quote the words of Sir Hartley Shawcross, a former British Attorney General in 1951,

"I think the true doctrine is that it is the duty of an Attorney General, in deciding whether or not to authorise a prosecution, to acquaint himself with all the relevant facts, including for instance the effect which the prosecution, successful or unsuccessful as the case may be, would have upon the public morale and order, and with any other considerations affecting public policy. In order so to inform himself, he may, although I do not think he is obliged to, consult with any of his colleagues in the Government, and indeed, as Lord Simon once said, he would in some cases be a fool if he did not(10)."

We expect that the Attorney General would follow Sir Hartley Shawcross's advice.

9.111. In summary, we recommend that while the new SC should maintain an investigatory team it should be able to appoint inspectors where it appears appropriate to do so. However, it must, in our view, avoid the trap of becoming an enforcement agency. For that reason, where inquiries indicate serious crime, the new SC should recommend the Financial Secretary to appoint his own inspectors. The SC should, of course, stand ready to offer its assistance.

(10) Hansard 1951, Vol. 483 Col. 682 et seq.

The SC would be responsible for prosecuting summary cases and for referring more serious matters to the Attorney General's Chambers for action.

SUMMARY

9.112. In summary, we recommend the establishment of a new statutory supervisor vested with the power to regulate the securities market. Its prime function would be to undertake regulatory oversight of the Exchanges and the clearing houses. It would be directly responsible for licensing securities and commodities dealers and investment advisers and for supervising non-Exchange securities activities, including fund managers, investment-linked life products and dealers in securities and commodities who do not act through the Exchanges. It should have authority to investigate and bring summary proceedings for statutory offences but should refer investigation and prosecution of serious crimes to the Financial Secretary and the Attorney General respectively for action. It should be outside the civil service, with full-time professional staff and governed by a board of directors appointed by the Governor, comprising executive directors and non-executive directors. It should report annually to the Governor and submit its annual budget to the Finance Committee of the Legislative Council. The new SC should be funded largely by the market but partly by the Government. It should be advised on matters of policy and market development by an Advisory Committee, comprised of members drawn from the securities industry and professions. Co-ordination with the Administration should be undertaken by a co-ordinating committee comprised entirely of office-holders chaired by the Financial Secretary.

CHAPTER X

THE REGULATION OF INTERMEDIARIES

INTRODUCTION

10.1. As we indicated in Chapter III, we do not believe that regulators should aim to eliminate broker failures or rule out customer losses. However, we do strongly believe that measures ought to be taken to ensure that the market and, in particular, investors can be confident that intermediaries are financially sound, honest and will give them a fair deal. In nearly all markets, this is achieved by subjecting intermediaries to entry requirements and continuing requirements. This chapter addresses these requirements under three headings : authorisation, financial controls and the conduct of business.

10.2. What follows concerns the rules for securities intermediaries. But these rules can only be effective if they are enforced. This requires the Exchanges and the new Securities Commission (SC)⁽¹⁾ to operate active surveillance programmes in respect of the dealers and advisers they supervise directly, as described in earlier chapters. This surveillance will be most effective if those responsible bear in mind the paramount need to understand the nature of each intermediary's business by frequent discussions with top management in addition to receiving regular returns and carrying out periodic audits. The aim should be to see the wood and not the trees. It is for that reason that this report generally puts so much emphasis on expert supervision by those familiar with market practices.

(1) See Chapter IX.

AUTHORISATION

Background

10.3. The current arrangements for authorising securities industry intermediaries are set out in the Securities Ordinance and the Commodities Trading Ordinance. As the two systems are similar, we have presented our arguments and recommendations in relation to the Securities Ordinance only.

10.4. Under the Securities Ordinance, it is an offence for a person to carry on a business of dealing in securities⁽²⁾ or to act as a securities investment adviser unless he is registered by the Commissioner for Securities as a dealer or an adviser or is granted exemption from registration. Each registration, whether as a dealer, an adviser or a representative, has a term of one year and must therefore be renewed annually. By contrast, exempt status runs until revoked.

10.5. The scope of the prohibition is wide and covers not only dealers but their representatives and representatives of investment advisers. In consequence equally wide exemptions exist. Some of these exemptions are discussed below.

(2) Dealing in securities is defined (in S.2(1) of the Securities Ordinance) as making or offering to make an agreement with any person, or inducing or attempting to induce a person to enter into or to offer to enter into any agreement : -

- (a) for or with a view to acquiring, disposing of, subscribing for or underwriting securities; or
- (b) the purpose or pretended purpose of which is to secure a profit from income or capital gain.

Dealers

10.6. Registered dealers include sole traders; companies and their directors; and the general partners of partnerships. Partnerships do not become registered dealers as such but rather become registered dealing partnerships (under Section 49A). The population of authorised dealers as at end November 1987 is summarised at Appendix 27.

10.7. Under Section 60, the Commissioner may grant **exempt status** to individual securities dealers on a case-by-case basis. This has the effect of exempting the dealer from many of the provisions of the Ordinance, including the Section 65B capital requirements. The Commissioner has discretion to grant such exemption if the firm concerned :-

- (a) is a licensed bank;
- (b) is a trustee company registered under the Trustee Ordinance;
- (c) is engaged mainly in non securities business and/or exempt securities business, which is defined as -
 - (i) new issue business
(the issuing of prospectuses; underwriting; making an invitation to subscribe for or purchase securities at issue etc);
 - (ii) unit trust or mutual fund business
(issuing a prospectus approved by the Commissioner for an authorised unit trust or mutual fund);

(iii) Government securities business; and

(iv) business with professionals

and the greater part of its securities business (other than exempt securities business) is conducted with or through a registered or exempt dealer or a member of an overseas stock exchange.

10.8. In consequence, exempt dealer status is not generally available to retail market firms, but it is greatly used by international bond firms and merchant banks.

10.9. There was a very substantial increase in exempt dealers during 1986 - from 132 to 215; of the 83 additions, eight were banks, 41 were deposit-taking companies and 22 were unit trust managers. This appears to have been prompted by firms wishing to escape new capital requirements for registered dealers.

Advisers

10.10. A person requires registration or exemption as an investment adviser if for direct remuneration he provides advice concerning securities; issues reports concerning securities; or undertakes portfolio management. However, the following are specifically excluded from the prohibition (i.e. they do not require registered or exempt status) : -

(a) a licensed bank;

- (b) a solicitor or professional accountant whose investment advisory activities are wholly incidental to the practice of his profession;
- (c) a bona fide newspaper or other periodical publication generally available to the public otherwise than on subscription (other than a publication whose principal object is to advise others concerning securities or to issue analyses or reports concerning securities);
- (d) a registered dealer or exempt dealer if the advice is incidental to his dealing business; and
- (e) a trustee company registered under the Trustee Ordinance.

10.11. In addition to the fairly large group of institutions which enjoy general statutory exemption, the Office of the Commissioner for Securities (OCS) may grant exempt adviser status to particular institutions on a case-by-case basis where the firm concerned provides investment advice mainly to businesses engaged in the securities industry; or to people and businesses outside Hong Kong.

10.12. As at end November 1987, there were only 16 specifically exempt advisers. This may be explained by the fact that registration does not entail a financial burden because registered advisers are not subject to capital requirements.

10.13. Only a registered investment adviser may issue any advertisement (including circulars and brochures) holding that person out as being prepared to give investment advice for remuneration; or to undertake for remuneration the management of investors' securities portfolios, unless the advertisements are directed solely to registered or exempt dealers or investment advisers (Section 5 of the Protection of Investors Ordinance). This restriction therefore applies to licensed banks and registered or exempt dealers.

Problems

10.14. Submissions to the Committee criticised the current system in a number of respects. It was said to be too complex, particularly in the light of its fairly modest achievements; and yet at the same time, it was apparently easy to obtain registration. Professional advisers were concerned that the distinction between securities dealer and investment adviser was unclear, with some arguing that it added little in terms of prudential supervision. Some were concerned about duplication between Exchange membership and OCS registration. Finally, exempt status was said to be conferred on too many people.

10.15. We therefore looked at the following issues :-

- (a) Exchange versus SC authorisation;
- (b) authorisation criteria;
- (c) annual registration versus licensing;
- (d) exemption;
- (e) the position of controllers, directors and managers;

(f) the position of dealing and advisory representatives; and

(g) the distinction between dealers and advisers.

Exchange versus SC authorisation

10.16. One possibility was to move to a system where a dealer would not need to be directly authorised by the SC provided he was a member of one of the Exchanges. While this would initially leave a large number of firms needing direct SC authorisation, it was suggested that in time, other industry bodies might develop which could take on a regulatory role for non-Exchange firms. This would be close to the UK system.

10.17. We rejected this route because we believe that a single body (the new SC) would be best equipped to set uniform minimum standards for trading in Hong Kong's markets. The numbers involved are small and one licensing body reduces duplication. Furthermore, the recent difficulties with the Exchange make it less appropriate for it to be granted the status of a licensing authority at present.

Authorisation criteria

10.18. Dealers/advisers should have to demonstrate to the satisfaction of the SC that they are fit and proper to conduct a securities business in Hong Kong. This should entail passing tests of honesty, competence (including experience), financial adequacy and the sufficiency of internal systems and controls. We also believe that dealers/advisers should be subject to a general requirement

to conduct their business prudently and adopt good business practices - this is considered below under "The Conduct of Business".

10.19. Finally, we believe that a business should only receive and retain authorisation provided and so long as it is actually undertaking a dealing business. This is quite a problem in Hong Kong as a number of registered dealers are inactive. We therefore recommend that the new SC should be empowered to revoke an authorisation which is not being used.

Annual registration versus licensing

10.20. We believe that the authorisation process needs to be greatly improved. It would seem that at present registration is granted semi-automatically. This is a matter of concern because, while entry standards must not be so prohibitive as to constrain the market's development, the integrity of entry requirements and procedures are one of the surest means of ensuring a sound market and of protecting investors. Furthermore, the admission of an applicant to the register tends to confer standing on the firm concerned and may be regarded as giving it a clean bill of health, thereby encouraging investors and intermediaries to deal with it.

10.21. The principal problems might be that the OCS has adopted a "nothing known against" approach or has placed greater emphasis on checking that a dealer is honest than on ensuring that he is competent. If that be the case, significant improvements could be achieved simply by strengthening some of the existing statutory criteria for registration and by enhancing the application process to ensure that the entry requirements constitute a substantive test.

10.22. However, we believe that, provided the supervisory system is adequate, an intermediary should remain authorised until its authorisation is surrendered or revoked. Little is achieved by annual re-registration. Indeed, the need to process around 6,000 renewals each year absorbs valuable regulatory resources and probably contributes to the semi-automatic nature of the process.

10.23. Apart from the resource savings, this would reflect a change in the official attitude to entry requirements and would therefore be a signal regarding the soundness and professionalism of the intermediaries active in Hong Kong's markets.

10.24. It was put to us that one of the merits of the existing arrangements was that annual registration carried a fee. There was concern that part of the OCS' income might be lost if annual re-registration was dropped. As already discussed in Chapter IX above, we believe that the new SC should be financed largely by the market. We therefore support an annual authorisation fee. However, this could be levied each year without an annual renewal system.

10.25. We therefore recommend that Hong Kong should move from a system of annual registration to a system of continuous licensing but that an annual fee should continued to be levied.

10.26. We recommend that licences should be granted to the business entity - company, sole trader or partnership - as this is the financial unit with whom other dealers and investors trade.

10.27. The Committee examined the possibility of requiring all registered dealers to submit themselves to re-authorisation upon the introduction of the new licensing system as this would give the authorities an opportunity to make a fresh start and establish new standards of entry. However, given that broker inadequacy or dishonesty is not Hong Kong's main problem, the burden which would fall on the SC (if the job were to be done properly) could not be justified. We believe it would be preferable for all firms who are registered on a specified day to be deemed to have been granted a permanent licence. This would be without prejudice to the SC's power to revoke. Meanwhile, the OCS should actively weed out firms which are not fit to be registered/licensed or do not need a licence or registered status.

10.28. We therefore recommend that there should not be a programme of relicensing intermediaries upon the introduction of an upgraded licensing system.

Exemption

10.29. We also believe that the current system whereby the OCS grants specific exemptions is defective in a number of respects. First, the OCS does not regularly review the institutions concerned to ensure that exemption is still warranted; indeed, the OCS lacks the powers and resources necessary to conduct such reviews, other than where there is cause to believe that there may be problems. Second, once granted, an exemption applies to any securities business undertaken by the firm, rather than just to the class of business being undertaken when the exemption was granted.

10.30. More specifically, we believe that, the prudential requirements placed on registered securities dealers should also be placed on many presently exempt dealers - such as licensed banks and deposit-taking companies (DTCs) - to the extent that they conduct a securities business. Furthermore, we do not believe there is a case for excluding so called exempt business, such as new issue business, Government securities business or mutual fund business, from the scope of supervision.

10.31. We therefore recommend that exempt status should be abolished and that, to the extent a firm conducts a securities business, it should be licensed, required to meet the appropriate standards on an on-going basis and supervised to ensure it meets those requirements.

10.32. It might, however, be necessary to amend the definition of securities business to ensure that the statute only catches those types of business that were intended to be caught. These would include banks and DTCs to the extent that they engage in securities business, mutual fund managers and life insurance companies in respect of the marketing of investment products.

10.33. Provision could also be made for secondary legislation to be introduced to exempt a class of institution⁽³⁾ or type of transaction. Such class exemptions should only be given where the statute was not intended to catch the class of business in question and where appropriate adequate alternative supervisory arrangements are in place.

(3) Such as the present exemption of accountants and lawyers.

10.34. Under the system we propose, a number of firms would need dual authorisation. For example, many banks/DTCs would have to become licensed securities businesses, which might prompt complaints that firms were being subjected to two potentially incompatible regimes of financial supervision. In our view, such criticisms would be justified. We believe that, to get over this, the new SC should rely on the Commissioner of Banking to apply and supervise the capital and liquidity adequacy of banks and DTCs with securities dealer authorisation, but should retain responsibility for applying and supervising the other requirements imposed on securities businesses (which are mainly concerned with the conduct of business).

10.35. We therefore recommend that, where a licensed securities business is also authorised and supervised by another body, provisions should exist for the new SC to be able to rely on that other body (such as the Commissioner of Banking or Insurance Officer) for the supervision and regulation of the firm's financial adequacy and soundness⁽⁴⁾.

Directors, controllers and managers

10.36. We recommend that in order for the new SC to grant a licence to a securities business, it should have to be satisfied that all directors, controllers⁽⁵⁾ and managers are fit and proper persons to hold their particular positions within the firm concerned and that,

(4) The issue of supervisory overlap is considered further in Chapter XIII below.

(5) Defined broadly as material shareholders or "persons in accordance with whose instructions the directors are accustomed to act".

collectively, they will ensure the firm is prudently managed and that it will comply with all the applicable regulations etc. Subsequent evidence that any of them is not (or has ceased to be) fit and proper should be grounds for revocation.

10.37. It would therefore be necessary for information on controllers, directors and managers to be provided to the licensing authority. Moreover, changes should be notified to the authority, possibly beforehand and subject to prior approval in the case of prospective controlling shareholders. The new SC would also need powers to act directly against controllers, directors and managers. We believe that, provided these arrangements and powers are in place, registration has little added value in this area as the necessary objectives can be achieved through the conditions for licensing the business entities themselves.

10.38. We therefore recommend that separate registration of directors, controllers and managers of investment dealers and advisers should not be required.

Representatives

10.39. Many representatives of securities firms have considerable autonomy in dealing with the public or in their market activities. Because they may not be directors or managers of their firms, they will not be covered by the firm's licence that will require all directors, controllers and managers to be fit and proper persons. But they deal directly with the public. They should only be able to act in this capacity provided (and for so long as) they are fit and proper to fulfil their duties as an adviser or trader. We therefore recommend that the system of requiring trading and advisory representatives to obtain authorisation should continue.

Dealers versus advisers

10.40. A number of people have suggested that separate authorisation systems for dealers and advisers are unnecessary. We note that, although registered (and exempt) dealers do not need to register as investment advisers if investment advice is peripheral to their business, many do in fact register as advisers (see Appendix 27). Equally, many investment advisers choose to register as dealers, possibly because they believe they may be dealers on account of any dealing they undertake as part of their fund management operations.

10.41. Dropping the distinction in favour of a system where a licence permitted a firm to act as a dealer or an adviser or both, would make the authorisation system simpler for all concerned. However, a distinction should be retained if materially different entry standards and/or on-going prudential requirements should be imposed on dealers and advisers. Alternatively, there might be a case for introducing a different category, say fund manager instead of adviser. We recommend that the new SC and the Administration should review whether separate licences are necessary for dealers and advisers (or for any other groups).

FINANCIAL REQUIREMENTS FOR SECURITIES DEALERS

Objectives

10.42. Capital adequacy is one of the most important parts of the regulatory apparatus given the priority of ensuring systemic stability and the protection of investors. While we believe the Exchanges are the appropriate bodies to monitor compliance with capital

rules, they should not develop the rules singlehandedly because of the risks of insider regulation and the need to ensure, so far as possible, that the same minimum requirements apply to Exchange members and non-members alike and to dealers in Hong Kong's non-equity securities markets.

10.43. We therefore recommend that the new SC should set basic minimum capital and liquidity rules for securities and futures intermediaries (apart from banks and any other licensed firms whose financial supervision is better undertaken by another statutory regulator) (6).

Purpose of capital adequacy rules

10.44. The basis of any set of requirements for broker-dealers is two-fold : first, a basic entry requirement to exclude the "fly-by-nights"; and secondly, a test designed to cover the risks in the business.

10.45. The details of the capital requirements must depend on the nature of brokers' business - what risks they run, what obligations they have, when they have to meet them and what resources do they have to achieve this? As agents, brokers take on short-term obligations which must be satisfied by the delivery of securities or the payment of cash. As principals, they generally take short-term positions. The profile of a firm's business can therefore vary considerably from day-to-day and, where position taking is material, there can be abrupt changes in its

(6) The position of futures dealers was covered in Chapter VIII above. This chapter concentrates on securities traders. The Exchanges' own capital requirement will have to satisfy these rules, but they may go further.

capital resources. In consequence, adequate liquidity must be maintained at all times to satisfy a firm's short-term obligations.

10.46. One way of approaching this is to calculate a firm's liquid assets and then test whether they cover the firm's short-term liabilities; in determining the level of liquid assets, a conservative view is taken of the realisable value of securities positions in a forced sale. An alternative approach is to examine the particular risks to which a broker is exposed and determine what level of capital resources is necessary to cover those risks; the main exposures are to position risk and counterparty credit risk. The two approaches are of course compatible.

10.47. Securities regulators tend to use a fairly broad definition of capital instruments but deduct non-liquid assets from capital and apply rigid rules as to the levels of capital which must be satisfied at all times.

The existing regulations

10.48. In Hong Kong, all registered dealers are subject to the same minimum net worth and liquid capital tests under Section 65B of the Securities Ordinance. The requirements are : -

<u>Registered dealers</u>	<u>Net capital</u>	<u>Liquidity margin</u>
Sole trader	\$1m	\$0.1m
Corporate	\$5m	\$0.5m
Partnership	\$5m for every corporate partner and \$1m for every other partner	10% of net capital requirement

10.49. The Stock Exchange of Hong Kong Limited (SEHK) has developed these statutory requirements, with the levels of capital increasing according to the number of SEHK shares held : -

<u>SEHK members</u>	<u>Net capital</u>	<u>Liquidity margin</u>
Individual	\$1m per share	\$0.1m per share
Corporate	\$5m if not more than five shares held	\$0.5m if not more than five shares held
	\$1m per share if more than five shares held	\$0.1m per share if more than five shares held
Dealing partnership	aggregate of the minimum individual requirements of all individual and corporate members of the partnership	aggregate of the minimum individual requirements of all individual and corporate members of the partnership

10.50. Net capital is defined as the excess of approved assets over ranking liabilities. Liquidity margin is defined as the excess of liquid assets over ranking liabilities. What counts as an approved asset, a liquid asset and a ranking liability is laid down in notices issued by the Securities Commission - The Securities (Specification of Approved Assets, Liquid Assets and Ranking Liabilities) Notice 1986 as subsequently amended by the Securities (Specification of Approved Assets, Liquid Assets and Ranking Liabilities) (Amendments) Notice 1987.

10.51. It is these definitions which determine the practical impact of the requirements. For example, most traded assets are included subject to a proportional haircut⁽⁷⁾ designed to reflect position risk: 20% for

(7) A reduction or discount off the value to provide a safety margin.

CDs, Floating Rate Notes, CP etc, and securities issued by the governments of Japan, Australia, Canada, Germany, UK and US; 40% for securities listed on the SEHK and other recognised stock exchanges, and also for units in unit trust and mutual fund shares. All other Government securities are effectively written off for regulatory purposes.

10.52. Counterparty risk is of two kinds : debts due from customers to be settled against the delivery of securities and margined lending. As to the former, debts outstanding for more than five trading days not otherwise secured must be written off for regulatory purposes⁽⁸⁾. The position as to margined lending debts is not entirely clear but there is a view that they may be recognised as assets for regulatory purposes to the extent of the current market value of the underlying collateral.

Problems and recommendations

10.53. A number of submissions called for an increase in the net worth requirements to \$10 million (or \$50 million for corporate brokers) in the wake of the October crash when nervous brokers requested banker's drafts from market counterparties. Some also argued for an increase in the liquidity margin. However, others argued that an onerous capital requirement should be avoided, as the main counterparty risk problem could be solved by the introduction of a central clearing system. Others still, including some major international investment banks, said that the current approach was crude and that it should be risk-based, taking account of volumes, levels of margin

(8) Securities (Specification of Approved Assets, Liquid Assets and Ranking Liabilities) Notice 1986 Para. 3.

trading etc. In our view, it is essential to distinguish between basic entry requirements and continuing business-related requirements.

10.54. Basic requirements are a crude test to ensure that those in the market have a reasonable level of resources, so that they can finance a back office and undertake a minimum of business. It is instructive in this regard to compare Hong Kong's requirements with other centres in the region⁽⁹⁾ : -

<u>Country</u>	<u>Requirement in \$ million</u>
Hong Kong	
(a) corporate	5.0
(b) individual	1.0
Australia	1.5
Korea	5.0
Malaysia	
(a) corporate	15.0
(b) private limited	6.0
(c) partnership	3.0
Singapore	39.0
Taiwan	
(a) agency	54.0
(b) broking : underwriting	163.0
(c) broking : underwriting and trading	272.0
Thailand	
(a) broker	1.5
(b) finance company with broking licence	6.2
Tokyo	18.8

(9) Source : Citicorp Scrimgeour Vickers. Exchange rates at 4 May, 1988.

10.55. A comparison might also be drawn with the Hong Kong Futures Exchange Limited (HKFE), which, for the Hang Seng Index market, imposes a basic \$5m requirement on brokers, but \$10m on individual clearing members and \$25m on general clearing members.

10.56. On balance, we believe that, on the face of it, the level of the Hong Kong net worth requirement is not unreasonable. However, we believe that both the net worth and liquidity margin requirements do not adequately reflect risk-related capital needs.

10.57. First, the requirement does not vary according to business volumes. It is imprudent to work on the basis that a major integrated securities firm needs precisely five times the absolute amount of excess liquid assets as much as a one-man broker with a small business. Nor do we believe that the share-based SEHK requirement is a significant step forward: a firm does not need precisely \$100,000 of additional excess liquidity simply because it has an extra seat. Both the UK and US requirements use proxies for business volumes, and indeed we believe this is increasingly the pattern worldwide.

10.58. Secondly, the margin lending risk provision is satisfactory only provided that a reasonable level of cash margin is actually always held by the brokers. This is discussed further in Chapter XIII below.

10.59. Third, even taking into account the volatility and special circumstances of the Hong Kong markets, the position risk haircuts seem rather tough on broker-dealers with an active own account business; they are much tougher than elsewhere - 5 to 10% against equities is not unusual. Harsh open position haircuts may be appropriate for agency

(10)
firms , but many of the big firms act on a principal-to-principal basis and can run quite large exposures as part of a quasi market-making business. For example, one firm estimated that 10% of its business involved position risk and that this would rise to 40 - 50% in a few years.

10.60. Fourth, only assets which form part of the firm's securities dealing business are treated as approved or liquid assets(11). Furthermore, only those assets specifically identified in the OCS' notice count as approved or liquid assets. This seems unduly punitive to firms which undertake other activities as it effectively means those assets have to be covered 100% by capital.

10.61. Fifth, the ratio is designed for stockbrokers and might not be appropriate for other types of securities dealer active in Hong Kong, such as bond traders. For example, subordinated debt injected by a parent which is not a stockbroker does not count as capital. This seems to us to have no basis of principle and in practice puts bank-owned brokers and other securities dealers in an unfavourable position versus pure stockbroking groups.

10.62. Finally, little account is taken of off-balance sheet risks apart from providing that provisions against contingent liabilities are to be included as ranking liabilities.

(10) Special consideration should be given to deals involving countries where exchange control exists, such as the Philippines, Thailand etc.

(11) The SEHK goes further by only allowing securities if they are traded on the Exchange.

10.63. A proper assessment of the adequacy of the requirements can only be made by the regulators who know the position of each firm in the market. But there are problems of design that need to be addressed and we therefore recommend that Section 65B of the Securities Ordinance and the SEHK minimum capital requirements should be reviewed at an early stage.

10.64. But minimum capital requirements are not enough for good supervision. There should be a system of amber lights by which intermediaries who are approaching, but have not yet breached, the limits should be required to advise the regulator so that early steps can be taken to adjust their business activities. We recommend that the new SC should consider introducing a system of early notification for capital levels.

THE CONDUCT OF BUSINESS

Background

10.65. It is important that firms should conduct their business according to high standards and that they should be fair in their day-to-day dealings with clients. To this end, most exchanges and markets around the world have rules governing the relationship between an investment intermediary and its customers or potential customers. These can cover a wide variety of matters: ranging from the issue of advertisements, giving of investment advice and recommendations, taking and effecting orders to rendering contract notes and preparing valuations. They also usually include supporting rules concerning documents so as to establish an adequate audit trail.

10.66. Conduct of business rules may be divided broadly into two categories: rules governing firm-customer relations and rules governing a firm's internal affairs to ensure that, even where they are not in direct contact with their customers, they still behave in a way which does not transgress key firm-customer relation rules. Secondly, some overseas systems distinguish between a firm's dealings with experts (such as market counterparties and professional investors) and private customers. Where such a distinction is made, the majority of firm-customer relation rules would not apply to a firm's dealings with its expert clients on the grounds that experts do not require the same level of protection as customers without special expertise or experience. Some examples of general conduct of business principles are set out in Appendix 28.

Current position

10.67. In Hong Kong, the Securities Ordinance has some provisions which fall within the ambit of business conduct rules. These are contained in Sections 72 to 85 of the Ordinance, which include rules governing offers by dealers (Section 72); cold calls by registered dealers (Section 73); hawking of securities (Section 74); the issue of contract notes (Section 75); the provision of copies of contract notes and customer's dealing accounts on request (Section 77); the representation of a dealer's abilities or qualifications (Section 78); the disclosure of certain conflicts of interest (Section 79); the holding of security documents (Section 81); the keeping of accounts (Section 83); and the segregation of clients' property (Sections 84 and 85).

10.68. The SEHK Rules also cover the conduct of business. For example, there are rules governing client agreements, discretionary accounts, fees, contract notes and dealing on a principal-to-principal basis. The requirements are, however, rather thin.

10.69. The HKFE covers business conduct in rules 425 to 453. They include a requirement to have standardised client agreements including a risk disclosure document; the handling of discretionary and omnibus accounts; the provision of certain information to clients; restrictions on staff trading on their own account; standardised commission rates; requirements for maintaining proper books and records; segregation of clients' funds; and the keeping of proper records.

Problems and issues

10.70. Against this background, we identified three policy questions : -

- (a) whether conduct of business rules were important in Hong Kong;
- (b) whether any such rules should have statutory backing; and
- (c) who should develop, promulgate and enforce any rules.

Need for conduct of business rules

10.71. On the basis of the submissions made to us and the discussions we held with market professionals, we believe that less than satisfactory business practices are apparent

in Hong Kong's securities markets; this is illustrated by the large number of complaints received by the Commissioner last year (Appendix 29).

10.72. In our view, neither the provisions in the Securities Ordinance nor the Rules of the SEHK are sufficiently comprehensive to provide adequate protection to the casual investor. In particular, they do not attack the issues at the heart of the business practice problem in Hong Kong which in our view are the need to know your customer, to make suitable recommendations and to provide best advice and best execution. The know your customer problem seemed particularly acute in the futures market prior to October 1987. Since then, the HKFE's new management has introduced a know your customer rule.

10.73. We were also told that compliance with the existing rules had not been satisfactory. Most notably, there have been widespread allegations regarding the failure of futures brokers to ensure that their clients understood the risks involved in buying stock index futures⁽¹²⁾. We were particularly concerned by numerous reports of sharp practices such as firms trading on their own account before client orders were fulfilled, of pledging clients' stock as security without permission from clients, and of stock lending from pools of supposedly segregated securities.

10.74. Against this background, we believe that measures must be taken to ensure an essential minimum level of protection for investors and to bring the local financial sector up to basic international standards.

(12) Since October 1987, the HKFE have taken steps to deal with this by issuing new rules about risk disclosure statements.

10.75. We accordingly recommend that business conduct rules should be developed in Hong Kong. Any rules should follow the general principles described above and should, where appropriate, distinguish between expert and non-expert customers.

Status of the rules

10.76. The regulation of firms' business conduct with their clients could be achieved in many ways. Any or all of the requirements could be enshrined in statute; set in statutory rules (secondary legislation); or in a code of conduct. Similarly, any requirements could be backed by a variety of sanctions : criminal, e.g. fine or imprisonment; civil, e.g. damages to the client; or regulatory, e.g. revocation of licence or withdrawal of membership by an exchange or other industry body.

10.77. The rules with statutory force approach adopted by the UK has been severely criticised. Rules aimed primarily at regulating business practices to ensure fair dealing and a duty of skill, care and diligence do not lend themselves readily to statutory definition and enforcement in the Courts. Statutory rules backed by criminal or civil sanctions would perforce have to be detailed. They would also tend to be inflexible precisely where flexibility is essential given that business practices change with the times.

10.78. We believe this approach would be wholly inappropriate for Hong Kong and therefore, rather than aiming to have legally binding, detailed rules covering all the aspects of a firm's business, we recommend that the conduct of business in Hong Kong should in the main be regulated by codes.

10.79. Having said that, we are in no doubt that Hong Kong should continue to enshrine some conduct of business rules in statute. This will be appropriate where there is a wish absolutely to prohibit a type of behaviour which is considered undesirable or against the public interest (e.g. fraudulent or misleading inducements, which are currently offences under the Protection of Investors Ordinance). We therefore recommend that consideration should be given to which of the current statutory conduct rules should continue in statute.

10.80. Furthermore, we believe that there should be some statutory backing for a good business practice requirement. In our view this should be achieved by licensed dealers (and advisers) being required not only to be honest, competent and solvent but also, inter alia, to adopt high standards of business practice. We therefore recommend that good business practices should be a condition for the licensing of intermediaries.

10.81. To give this some substance, the regulators could issue a statement of general principles. This should not go into details and should not be drafted in a way that fetters the discretion of the new SC to act against a dealer with poor business practices not covered by the statement of principles or whose practices it might be argued did satisfy the letter of the statement. We accordingly recommend that the legislation should require the SC to issue guidelines setting out how they would expect to apply the good business practices criterion in normal circumstances.

10.82. But the guidelines would be mere bones. The flesh would come from Codes of Conduct.

Developing and policing the codes

10.83. Our preference is for codes produced by market bodies, as we believe codes covering business conduct have a better prospect of realistically grappling with the right issues if they are devised by market practitioners and, moreover, that they are more likely to be effective if practitioners themselves promulgate and, to a large extent, enforce them. We also feel that, as a matter of principle, practitioners ought to be involved in order to further the development of a self-regulatory approach to investor protection in Hong Kong.

10.84. We are doubtful, however, that much will happen if the matter is left entirely in the hands of the industry because self-regulation is insufficiently developed here and industry associations are not yet ready to take on the role. Furthermore, there is a large group of practitioners who are not members of any exchange or industry association.

10.85. We therefore recommend that there should be strong SC encouragement for the development of codes. Giving good business practices statutory backing in the licensing conditions and the issue of SC guidelines should help. In addition, the SC should prod the industry to develop codes and should help in their preparation. The SC could bless the codes that result but we believe strongly that any formal statutory approval of codes is inappropriate.

10.86. As to which industry bodies should be involved, we believe that what is appropriate for, say, the Hong Kong stock market may not work in, say, the futures market. Precisely who should do what should, therefore, be left to the authorities to work out in conjunction with the industry, but it would seem sensible to build on existing bodies.

10.87. Our own feeling is that it would be preferable for the Hong Kong Stockbrokers Association rather than the SEHK to develop the stockbrokers' code. This is because codes of conduct are the natural preserve of trade associations and, furthermore, the SEHK is going to have more than enough on its plate. A similar approach appears to have worked well in Japan, where the Securities Dealers Association has responsibility.

10.88. Indeed, the obvious starting point is the Hong Kong Stockbrokers Association. The Association, in conjunction with the SEHK, should be assisted by the SC in developing the necessary capacity and capability for monitoring and policing the code. It would show the way for other industry bodies to follow. Although the same approach might in principle be taken in the futures market, there is no industry association and the HKFE has already done a lot of work in this area; we therefore believe it would be preferable for the HKFE to continue to take the lead.

10.89. The onus for enforcing breaches of codes should in the first instance lie with the sponsoring bodies concerned. But the SC should develop a close relationship, on an informal non-statutory basis, with the sponsoring associations to ensure that they do in fact enforce their respective codes. In particular, all allegations of breaches should as a matter of practice be reported to the SC, together with a report of follow-up action taken.

10.90. In addition, the SC and the Exchanges should cover code compliance in their spot checks and audit of licensed intermediaries. In the case of the SC, this would be done under its statutory powers. It should report any breaches uncovered in the course of their audit to the relevant sponsoring body.

10.91. The approach we propose therefore is gradualist. What is needed is some general guidance on business practices and a set of generally accepted standards; not a strict, legally binding set of rules. Similarly, the objective should be steady progress in the development of codes of practice. It is not necessary for every single business area to be the subject of a code in a year's time. An undue rush or long delays would both be fraught with pitfalls.

10.92. We should acknowledge that the proposed arrangements will contain gaps. First, in many areas, industry associations do not exist at present; for example, futures brokers who are not HKFE members are not subject to HKFE rules or to any other code. Second, intermediaries are not obliged to join market associations. Third, the SC will not have any powers to force industry associations to develop and enforce codes (other than the two Exchanges). In the absence of direct SC action, some areas of activity will not be subject to a code. It will be important to keep the gaps under review and to press for continuing progress in this area.

10.93. We believe Hong Kong should avoid statutory recognition of trade associations; detailed, statutory rules; and powers to ensure that trade associations are enforcing codes. The objective should be to develop a new climate, not to put intermediaries in constant legal jeopardy or to usher in a vast regulatory apparatus. In short, we recommend that Hong Kong should develop voluntary industry codes blessed (but not approved) by the SC and backed by a broad statutory requirement for sound business practices as developed in general non-statutory guidelines to be issued by the SC.

SUMMARY

10.94. In summary therefore we recommend :-

Authorisation of intermediaries

- (a) Hong Kong should retain a system of authorisation to trade by the statutory regulatory body, the SC;
- (b) but it should move to a system of authorisation based on licensing rather than registration;
- (c) licences should last until revoked, with no annual reprocessing as at present but with annual fees;
- (d) exempt status for individual firms should be abolished, so that all securities businesses must be authorised;
- (e) arrangements should be introduced whereby the Commissioner of Banking would be responsible for supervising the financial soundness of banks/DTCs who are also licensed securities dealers; but the SC would be responsible for non-financial regulation;
- (f) the system of separate registration for directors should be abolished, but a condition of licensing a firm should be that all its directors, controllers and managers are fit and proper;

- (g) authorisation for representatives should continue;
- (h) the SC and the Administration should review whether separate authorisation arrangements are needed for dealers and advisers (or for any other groups);

Capital requirements

- (i) the capital requirements in Section 65B of the Securities Ordinance should be reviewed at an early stage with the objective of ensuring in particular -
 - (i) that proper account is taken of differing business volumes;
 - (ii) that all risks are adequately covered but that excessive capital is not required to cover particular risks;
 - (iii) that the requirements are broadly fair as between different types of business; and
 - (iv) that they are easy to understand and apply;

Business conduct

- (j) standards of business conduct should be codified in Hong Kong;

- (k) apart from certain important statutory penal provisions, there should not be statutory rules backed by criminal or civil sanctions but good business practices should be made a condition for the licensing of dealers (and advisers);
- (l) the SC should issue general Guidelines for the good business practices criterion, leaving it to industry bodies to flesh them out in the form of codes of practice;
- (m) the ultimate sanction for poor business practices should be the withdrawal of the dealing licence;
- (n) the SC should take the lead in the development of the first codes; and
- (o) the new SC should be given adequate powers and resources to monitor compliance and ensure enforcement.

CHAPTER XI

THE MARKETING OF NEW ISSUES

Introduction and objectives

11.1. This chapter considers the issue and marketing of securities and other investment products. An equity investor's ultimate financial exposure is not to a stockbroker but rather to the listed company concerned. While there is no suggestion that an equity investment should be low risk or that regulators should take steps to prevent a company's failure, regulators have been active in this field to ensure fair markets and the protection of investors - the third and fourth of the objectives we identified in Chapter III. We believe that the regulation of new issues and listed companies is important because it sits right at the heart of the regulatory regime⁽¹⁾.

11.2. To this end, the regulator generally aims to ensure four things :-

- (a) that the issue of securities is fair and orderly and is accompanied by sufficient information to enable prospective investors to make an informed judgement;
- (b) that shareholders are subsequently fully informed of significant developments affecting the value of their company or investor's views of the company;

(1) It is no accident that the US Securities and Exchange Act opens with provisions on the issue of securities, not on the regulation of broker-dealers.

(c) that all shareholders are treated alike;
and

(d) that intermediaries and advisors act
fairly towards their clients and do not
mislead them.

11.3. Of these, the second and third concerns are covered in Chapter XII on the continuing obligations of listed companies. The last relates to the conduct of intermediaries and advisors. We consider this in Chapter X. We now consider the first aspect - the issue of securities.

Background

11.4. The principal statutory and non-statutory rules governing the marketing of new issues in Hong Kong are :-

(a) the Protection of Investors Ordinance;

(b) the Securities Ordinance;

(c) the Companies Ordinance;

(d) the Securities (Stock Exchange Listing)
Rules made under the Securities Ordinance;
and

(e) the non-statutory SEHK listing rules.

Generally speaking, they follow the international consensus that the provision of adequate and timely information is the foundation of a fair and orderly market.

Protection of Investors Ordinance

11.5. In broad terms, the 1974 Protection of Investors Ordinance makes it an offence to issue advertisements and documents relating to securities and other investment arrangements save as follows :-

- (a) Sections 4(2)(a) and (c) - an issue of a registered prospectus (or an application form accompanied by a prospectus);
- (b) Section 4(2)(d) - an underwriting agreement;
- (c) Section 4(2)(g) - documents given prior authorisation by the Securities Commission, subject to any conditions it sees fit to impose under Section 4(7);
- (d) Section 4(3)(a)(i) - where the advertisement or invitation to invest in securities is made by a registered or exempt securities dealer (or a registered adviser) (2);
- (e) Section 4(3)(a)(vii) - where the issue is aimed at persons outside Hong Kong or to persons in Hong Kong "whose business involves the acquisition, disposal, or holding of securities, whether as principal or agent" (commonly referred to as the professional investors exemption); and

(2) This exclusion only relates to securities and therefore does not cover other investment arrangements.

(f) Section 4(5)(b) - where a written invitation is issued only to registered securities dealers or advisers.

11.6. The combined effect of (c), (d) and (e) is that a registered securities dealer must obtain the prior permission of the Securities Commission before it markets to the Hong Kong public any investment arrangement which does not relate to securities.

11.7. The provisions of the Ordinance are administered on a day-to-day basis by the Office of the Commissioner for Securities (OCS).

Securities Ordinance

11.8. The Securities Ordinance (Part VIII) imposes three principal constraints on the way securities can be marketed.

11.9. The written offer rule. Section 72 (taken together with Section 3) requires a dealer to make any offers to acquire or dispose of corporate securities in writing, except where the offer is :-

(a) to an existing shareholder;

(b) to an established customer (defined as a customer for whom the dealer has transacted at least three deals in the previous three years);

(c) to a person whose business involves the acquisition or disposal or holding of securities (the so-called professional investors exemption);

(d) made by a stockbroker to another stockbroker on the SEHK;

(e) to a registered or exempt dealer; and

(f) made via a registered or exempt prospectus.

11.10. The written offer must be in both English and Chinese and must contain specified information about the company and securities concerned. The information required for purchases and disposals is set out in the First and Second Schedules to the Ordinance respectively.

11.11. **The cold calling rule.** Under Section 73, a registered dealer is prevented from striking a deal to sell securities to a client following a cold call, except where the client is already a shareholder of the company concerned, is an established client of the dealer, or his business involves the acquisition or disposal or holding of securities (the professional investors exemption). The dealer may enter into an agreement to sell, however, provided that he called at the invitation of the client and first gave his client the written information required under Section 72. Under Section 73(4), a client may rescind a contract which breaches this requirement within four weeks of the deal.

11.12. **Hawking of securities.** Under Section 74, no person (whether a dealer or not) may call from place to place to sell securities (i.e. to hawk), whether by telephone or visit or otherwise, except where the person contacted is a registered or exempt dealer or adviser, a banker, a solicitor or a professional accountant. It is important to note that, in marked contrast to Sections 72 and 73, there is no exception for calls on established clients or professional investors.

11.13. The statute provides for regulations to exclude certain transactions from these sections but none has ever been made. Responsibility for ensuring compliance with the provisions falls to the OCS.

Companies Ordinance

11.14. The Companies Ordinance lays down disclosure requirements for offers of securities to the public, whether listed on the SEHK or not.

11.15. Section 38 provides that any offer to the public of shares or debentures in a Hong Kong-incorporated company must be by way of a prospectus whose contents comply with the requirements of the Third Schedule to the Ordinance. That Schedule provides, inter alia, that a prospectus must contain sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the shares etc.

11.16. Under Section 38A, the Registrar of Companies may exempt a prospectus from complying with all or any of the Third Schedule requirements, having regard to the particular circumstances of the issue.

11.17. Under Section 38D, each prospectus must be registered with the Registrar of Companies before issue. In addition, the prospectus must first be approved as the Ordinance provides :-

- (a) that the Registrar of Companies may refuse to register a prospectus if it does not comply with the Ordinance or contains any information likely to mislead (Section 38D(5)); and

(b) that no prospectus shall be issued until a copy has been delivered to the Registrar and, if the prospectus is issued without a copy having been registered, the company and any other person who is knowingly a party to the issue of the prospectus shall be liable to a fine (Sections 38D(1) and (6)).

11.18. Section 40A provides that any mis-statements in a prospectus constitute a criminal offence, with offenders liable to a fine and imprisonment.

11.19. There are a number of exemptions from the prospectus requirements : for example, underwriting agreements (Section 38(3)(a)) and rights issues (Section 39(5)(a)). In addition, under Section 38(3)(b), the requirements do not apply to offers which are not made to the public, so that private placements do not need to be accompanied by a prospectus. The term private placement is not defined as such, but Section 48A makes provision for construing references to offering shares to the public and also states that under certain circumstances, an offer is not to be treated as made to the public if it was not calculated to result in the shares being available to persons other than those receiving the offer. In addition Section 343(2) of the Companies Ordinance provides a "professional investors exemption" for offerings by foreign companies.

11.20. The above complex prospectus requirements are administered by the Registrar General's Department. In addition, listed issues are subject to the statutory listing requirements administered by the OCS and the SEHK's own listing rules.

Securities (Stock Exchange Listing) Rules

11.21. In February 1986, the Securities Commission introduced the Securities (Stock Exchange Listing) Rules (here referred to as "the Commission's Rules") under Section 14 of the Securities Ordinance. These set out the requirements for securities to be listed; determine the application procedure; require listed companies to enter into a prescribed undertaking with the Exchange; and provide for cancellation of listing if they are violated or if cancellation is necessary to maintain an orderly market.

11.22. Subject to certain exemptions Rule 4 requires all listing applications made to the SEHK to be served on the Commissioner. It may grant a listing only if the Commissioner has not objected within seven working days. He may object if the applicant fails to comply with the Rules; the application contains false or misleading information; the applicant does not employ an approved share registrar; or the listing is not in the public interest.

11.23. The Commissioner may direct the SEHK to suspend dealings in a security if false or misleading information has been given by the company during the listing process (Rule 5), or if the company fails to comply with the terms of its undertaking (Rule 9).

11.24. Rule 7 provides that a listed company must enter into an Undertaking with the SEHK which sets out the continuing obligations of the company, particularly with regard to disclosure. The objectives are to enable the investing public to appraise the financial position of the company and its subsidiaries; to avoid the establishment of a false market; and to ensure that information likely to cause a material price change is published.

11.25. In broad summary, items to be disclosed include the annual report and accounts, interim reports, various "notifiable" transactions, the acquisition and disposal of material assets and subsidiaries, certain information after board meetings, declaration of dividends, changes in the terms of convertible debentures, etc.

11.26. The Commission's Rules are administered by the OCS. As will be seen from Appendix 30, this involves a great deal of work for the OCS.

SEHK rules and role

11.27. Under Section 34(1)(a) of the Stock Exchanges Unification Ordinance, the SEHK is also empowered to make rules on listing provided they are approved by the Commission and are consistent with the Commission's Rules⁽³⁾. Such rules were introduced in June 1986. They are non-statutory. The SEHK's administration of its listing rules was described in Chapter V above.

11.28. The Exchange's rules set out the general principles governing admission of securities to listing, and detailed provisions regarding applications, disclosure of information, method of listing, etc.

11.29. Every new issue must be supported by a prospectus. The prescribed contents overlap considerably with the Third Schedule to the Companies Ordinance.

(3) Where any provision in the Exchange Listing Rules is in conflict with any statutory provisions, the latter prevail.

11.30. The Exchange's listing requirements are, inter alia, that the company concerned must be a public company; its business should be of sufficient public interest; its market capitalisation must initially be at least \$50 million (or such other amount as the Exchange's Listing Committee may prescribe); normally at least 25% of the class of securities concerned must be offered to the public; the company must have a trading record of adequate duration; and there should be no conflict of interest arising from the relationship between the company and any substantial shareholder (defined as a person controlling 35% or more of the votes).

11.31. The on-going requirements expected of a listed company are set out in the Listing Agreement. This incorporates the Undertaking required by the Commission's Rules and is discussed in Chapter XII.

11.32. The Exchange's rules empower the Listing Committee to suspend or cancel the listing of a company if, inter alia, there is insufficient public interest in the company; the company fails to comply with the Exchange's rules or the Listing Agreement; the company becomes a subsidiary of any other company; or cancellation or suspension is in the public interest.

11.33. The SEHK is required by Rule 14 of the Commission's Rules to give the Commissioner 48 hours prior notice of any intention to cancel a listing; and if possible prior notice of a suspension.

Problems

11.34. On the basis of submissions and discussions with merchant banks and professional advisors, we identified a

number of problems with the current arrangements. These are discussed in the following paragraphs.

Private placements

11.35. The scope of the private placement exemption under the Ordinances is uncertain, indeed it has been suggested that the uncertainty is so great that the exemption cannot be relied upon. The UK is currently in the process of adding precision to their equivalent exemption.

Professional investors exemption

11.36. It is not clear why the professional investors exemption in the Companies Ordinance applies only to prospectuses for foreign issues and not to domestic issues. Hong Kong followed the UK in this respect but the origins of the UK approach are also unclear and in any case the UK position is being changed. It might be argued that as a matter of policy, the Administration should take greater steps to protect Hong Kong investors from domestic issues than from foreign issues. We, however, reject this argument.

11.37. Secondly, for no apparent reason the professional investors exemption in the Protection of Investors Ordinance and the Securities Ordinance is wider than its equivalent in the Companies Ordinance. The Companies Ordinance exempts offers to those whose ordinary business is to buy and sell securities, whereas the Securities Ordinance and Protection of Investors Ordinance equivalents exempt dealings with persons whose business merely involves securities trading.

11.38. Thirdly, there is some uncertainty as to the scope of each of the exemptions.

Sections 72 to 74 of the Securities Ordinance

11.39. Taken together, it is possible that these provisions prevent a securities dealer from undertaking any marketing apart from issuing limited circulars. For example, Section 74 might prevent a broker from visiting or telephoning an established client. Thus, while they are aimed at preventing malpractice, their scope is too wide. We were advised that it was extremely unlikely that these important provisions were obeyed.

Companies Ordinance control of offers to the public

11.40. It is worth noting that the UK no longer bases its prospectus requirements on the concept of an offer to the public, because of difficulties in interpretation. We believe that Hong Kong should review the provisions with a view to reducing their complexity. An objective for the review should be to produce provisions which permit reasonable practices but protect the general public from malpractices.

A review of the statutes

11.41. Statutory provisions in this area are almost inevitably the most complex part of securities law since they must cater for different types of security, different types of issue, different types of issuer, different types of investor and different types of issuing house. In other words, it is a five-dimensional matrix. Scattering the

provisions amongst four enactments compounds the problem and leads to uncertainties and inconsistencies. As the Hong Kong Law Society argued in a 1982 submission to the Securities Commission,

"there must be little justification for the fact that an offer of shares in a close-ended investment company is governed by theCompanies Ordinance, an offer of units in a Unit Trust or shares in a Mutual Fund is governed by the Securities Ordinance, the Protection of Investors Ordinance (or the Companies Ordinance) and the Hong Kong Code on Unit Trusts and Mutual Funds, but that an offer of insurance policies or "bonds" which are effectively purely equity investments with nominal insurance cover attached is virtually free of restriction."

11.42. Moreover, apart from being unduly complex, the Hong Kong legislation is also outdated. It is based heavily on legislation, from the UK and elsewhere, which has now been thoroughly reviewed and updated. For example, the UK has brought all the relevant provisions together into two documents: a single statute - the Financial Services Act and the Stock Exchange's listing rules.

11.43. We were also advised that there was a whole host of other technical but important defects but, in the time available, we have not been able to look into them.

11.44. We therefore recommend that there should be a review of the Hong Kong legislation covering the marketing of securities and other investments with a view to an early update and the consolidation of the statutory provisions in

a single Ordinance. In our view, this should involve private sector securities lawyers, preferably with experience of US and UK law and practice.

Duplication of effort

11.45. At present, new issues are subject to the following approvals :-

<u>Type of issue</u>	<u>Vetting by and permission from</u>
Listed securities	Registrar General OCS SEHK
Unlisted securities requiring a prospectus	Registrar General
Marketing of CDs, CP, etc.	Securities Commission

11.46. We believe that this involves unnecessary duplication and have, therefore, considered in some detail the questions of whether prospectuses should be vetted at all; and if so, by whom?

11.47. On the first question, we believe it is appropriate to distinguish between listed and unlisted issues. The prospectus to an issue of listed securities provides the market with the information needed for investors to assess the securities and will be kept up to date by on-going disclosure in accordance with market rules. For example, in addition to regular reports, any

price-sensitive developments will have to be reported to the market when they occur. In this case, pre-vetting is a logical part of the Exchange's regulation of the market.

11.48. A prospectus to an unlisted issue, by contrast, is a one-off snapshot intended to form the basis of a contract between offeror and individual subscribers. There will be no on-going disclosure except that required periodically by company law.

11.49. The case for vetting unlisted issues is that it is the surest way to ensure compliance with the statutory requirements and that high standards are maintained. The argument against is that it should be sufficient to rely on professional advisors (lawyers, accountants and merchant bankers) to ensure compliance and the maintenance of standards, with the regulatory body merely acting as an enforcement agency. Indeed, pre-vetting might dilute the responsibility of issuers and their advisers for the completeness and accuracy of their offer documents.

11.50. In addition, there are doubts about the effectiveness of pre-vetting, as a pre-vetting authority cannot be expected to check the accuracy or completeness of an offer document in any meaningful way. The fact that a document has been pre-vetted may therefore give investors a false sense of security.

11.51. On balance, we are not convinced that it is essential to continue with the pre-vetting of unlisted issues. This question should be reviewed by the Administration..

11.52. As to who should vet, it is helpful to understand the historical basis of the current arrangements. The

Registrar of Companies has been vetting prospectuses, for both listed and unlisted issues, since 1972 when amendments were made to the Companies Ordinance upon the recommendation of the First Report of the Companies Law Revision Committee. In fact, the Committee pointed out⁽⁴⁾ that there would be advantages in the new Commissioner of Securities also being the Registrar of Companies. This suggestion was not implemented, so there has been some duplication of effort all along.

11.53. As we understand it, the Commission's Rules have their origins in the variable low listing and disclosure standards prior to the unification of the four exchanges in 1986 and also the uncertainty in the minds of the authorities about the quality of regulation the new Unified Exchange would provide. They, therefore, represented minimum statutory standards for the Unified Exchange.

11.54. Notwithstanding this background, we believe it is critical not to waste scarce regulatory resources by duplication of effort. We therefore recommend that the existing system should be rationalised and streamlined so that only one body vets and approves documentation on new issues.

11.55. We further recommend that the vetting of prospectuses for issues of listed securities should be undertaken by the SEHK, subject to the very important conditions that satisfactory safeguards should be put in place and the change should only occur when there has been a sufficient improvement in the professionalism and independence of the Exchange's Listing Division.

(4) Para. 6.20 of the CLRC Report of 1971.

11.56. As regards the current duplication between the OCS administering the Commission's Rules and the SEHK administering the Exchange's rules, we recommend that, if the SEHK is to be the sole "vetter" of listed issues, the Commission's Rules should be repealed. In their place, the Securities Commission should be given reserve powers in the main legislation to forbid, suspend or cancel a listing. The disclosure provisions of the Commission's Rules would become part of the SEHK's rulebook and the current Undertaking would become part of the SEHK's own continuing obligations.

11.57. It is arguable that, as in London, the Listing Agreement should be dispensed with since companies and their directors undertake in their application to comply with the continuing obligations in the Listing Rules. However, we believe that having to sign a further agreement helps to bring listed companies' attention to their on-going obligations.

11.58. As regards the Companies Ordinance, we believe that the prospectus to a listed issue should continue to be delivered to the Companies Registry. It is important that all the significant documents relating to a company should be on the public record and, for convenience, should be in a single place.

11.59. As to the substantive position under the Companies Ordinance, it might be possible to give the SEHK, as the recognised Exchange Company, authority to approve a document as complying with the Third Schedule. However, we recommend that a listing document should simply be exempt from the Third Schedule requirements if it complies with the SEHK's rules and is approved as doing so by the SEHK.

11.60. As to unquoted securities, there is a strong case for the Registrar General transferring its responsibilities to the new Securities Commission (SC)⁽⁵⁾, the body charged with having specialist expertise on new issues and related commercial matters. We therefore recommend that, if it is decided to vet unquoted issues, the task of approving the prospectus should fall to the specialist statutory securities market regulator i.e. the new SC.

11.61. To achieve this transfer of responsibilities, provision would need to be made in the Companies Ordinance to enable the Registrar General to register a document which had been approved by the SC as complying with the Third Schedule.

Summary

11.62. To sum up, the problems are :-

- (a) that the requirements are overly complex, difficult to use because they are scattered through too many statutes and rulebooks and, in many cases, badly need updating to cater for developments in securities market practices; and
- (b) that the administration and application of the law and rules is also overly complex with duplication of effort by the Registrar General's Department, the OCS, the Securities Commission and the SEHK.

(5) See Chapter IX.

11.63. Our main recommendations therefore are :-

(a) that statutory provisions on new issue documentation and advertising should be thoroughly reviewed with the objective of their being consolidated and updated in a single statute; and that, in particular, there should be a review of -

(i) the "private placement" exemptions;

(ii) the scope and consistency of the "professional investors" exemptions; and

(iii) the effectiveness of Sections 72-74 of the Securities Ordinance;

(b) that the Administration should review whether it needs to continue pre-vetting the documentation to unquoted issues;

(c) that, where there is vetting, it should be by only one body rather than two or three;

(d) that, in particular, once its Listing Division is sufficiently improved, the SEHK should have sole responsibility for vetting and approving listed issues, and that to facilitate this -

(i) the Commission's Rules should be repealed, with the SEHK rules being expanded where necessary;

(ii) listed issues should be exempted from the Third Schedule; and

(iii) the new SC should have reserve powers to act if SEHK falls down on the job; and

(e) that, if pre-vetting of unlisted issues continues, the new SC should assume responsibility from the Registrar General's Department for vetting and approving prospectuses.

11.64. Finally, it is essential that the transfer of responsibilities to the SEHK should only occur when its Listing Division has proved itself up to the job. We therefore recommend that the new SC should initially audit the SEHK Listing Division at six monthly intervals and that its role under the Commission's Rules (and the Registrar General's role under the Companies Ordinance) should not be transferred until it is satisfied that the SEHK is up to the job. For this purpose, the new SC should appoint outside inspectors, with international experience, to advise it.

CHAPTER XII

CONTINUING OBLIGATIONS OF LISTED COMPANIES

Introduction and objectives

12.1. In Chapter III, we stressed the need for fair markets, free from manipulation and deception, so that no unfair advantage accrues to any participant and shareholders in a public company are treated equally. We highlighted the importance of price transparency and disclosure in achieving this. The problems connected with the initial listing and marketing of securities were discussed in Chapters V and XI. This chapter deals with the continuing obligations of companies after they have been listed.

Background - the SEHK Listing Agreement

12.2. Apart from the Companies Ordinance (which covers disclosure via annual accounts), the main obligations of listed companies stem from the Listing Agreement which every listed company must sign and which is a formal acknowledgement of its relationship with the Stock Exchange of Hong Kong Limited (SEHK). Compliance is essential to a continuing listing.

12.3. The Listing Agreement incorporates the statutory provisions of the Undertaking prescribed by Rule 7 of the Securities (Stock Exchange Listing) Rules and includes further non-statutory provisions considered desirable by the Exchange.

12.4. It imposes standards of disclosure higher than those of the Companies Ordinance. In particular, it requires : -

- (a) prompt publication of details of all major acquisitions and disposals;
- (b) additional information to be contained in the annual report;
- (c) publication of interim reports; and
- (d) publication of any information relating to the company and its subsidiaries which is necessary to enable assessment of the company's financial position, or which is necessary to avoid the establishment of a false market or which would be likely to cause a material price change⁽¹⁾.

12.5. In essence, the agreement aims to secure the immediate release of information which might reasonably be expected to have a material effect on market activity and the price of listed securities; to ensure proper conduct of the company in relation to shareholder's rights; and to ensure the maintenance of a fair and orderly market.

12.6. This is an area of particular concern in Hong Kong because a number of submissions alleged that there is a general failure by listed companies in Hong Kong to disclose sufficient information on a continuing basis and the demarcation between the public and private interests of controlling shareholders is not scrupulously respected.

(1) It is this requirement which appears to cause the greatest difficulty in interpretation. We have been told that it is too vague.

12.7. The main problem areas highlighted in the submissions were : -

- (a) disclosure in annual accounts and prospectuses;
- (b) disclosure of material shareholdings;
- (c) directors' dealings; and
- (d) approval of major transactions.

We examine each of these areas in the following paragraphs.

Accounting information

12.8. The consensus of expert opinion is that the disclosure requirements relating to the published accounts of listed companies in Hong Kong are broadly in line with international practice. The major problems with published accounts are that compliance with the existing regulations is unsatisfactory and is not adequately monitored, and that companies are reluctant to disclose additional information, beyond that specifically required, even where this appears to be necessary for the accounts to give a true and fair view of the company (which is required under the Companies Ordinance).

12.9. The following specific enhancements have been called for : -

- (a) disclosure of related party transactions:
in particular, there is no requirement to disclose material, non-arm's-length transactions between related parties or major transactions between a listed group of companies and a private group under common control;
- (b) disclosure of substantial shareholdings;
- (c) disclosure of dealings with shadow directors;
- (d) full profit and loss accounts, identifying inter alia cost of sales, operating expenses and interest income and expense (as required by the Fourth Schedule to the UK Companies Act 1985). The present procedures only require the disclosure of turnover, operating profit and certain narrowly defined categories of expense; and
- (e) five year summaries of results and financial position.

12.10. We believe that the proposed enhancements are in the right direction and therefore recommend that the SEHK should carefully review current disclosure requirements with a view to making improvements.

12.11. Moreover, there is concern that accounts may not always show a true and fair view; although current regulations may be complied with to the letter, companies may not go far enough to provide a true and fair view. We believe that companies and their auditors should be brought to understand that providing a "true and fair view" is the over-riding requirement. We understand that the UK law has recently been amended to stress the over-riding requirement. Hong Kong should consider following suit. We therefore recommend that the Companies Ordinance should be amended to provide that the requirement for accounts to show a true and fair view overrides other provisions.

Material shareholdings

12.12. In June 1987, the Government published the Securities (Disclosure of Interests) Bill which is, to quote the long title, a bill "to require certain persons holding shares in or debentures of listed companies to disclose their interest in those shares or debentures". The main objects of the Bill are : -

- (a) to force disclosure of shareholdings of 10% or more within five days of the duty arising. The Bill looks through corporate interests to get at the reality of the controlling shareholder;
- (b) to give companies the right to require a shareholder to provide information about his holding;

- (c) to force the directors and chief executive of a listed company to disclose their interests in the company and of any dealings in the company's shares; and
- (d) to enable the Financial Secretary to appoint inspectors to investigate the ownership of a listed company.

12.13. We believe these objectives (and the Bill generally) are laudable. We are, however, of the view put forward in a number of submissions to us that Hong Kong should aim to lower the disclosure threshold from the 10% in the Bill to 5% because : -

- (a) 5% falls in line with international practice;
- (b) 10% of a company's capital in Hong Kong is likely to be a much higher percentage of the free float⁽²⁾ than in other countries and consequently 10% of the free float wields a disproportionate amount of influence to its size;
- (c) 10% makes it too easy for large investors to hide significant shareholdings and consequently to conceal their dealings in those shares; and
- (d) 5% would be more effective in stamping out material insider trading.

(2) Free float means that part of the company's capital which is publicly traded.

We therefore recommend that legislation should require disclosure of company shareholdings above 5%.

Director's dealings

12.14. It is natural and desirable for directors of public companies to hold shares in their company, however they will from time to time be in possession of privileged information regarding the company's affairs.

12.15. In the UK, rules guiding directors are contained in the "Model Code for Securities Transactions by Directors of Listed Companies", which forms part of the continuing obligations of a listed company. The Code provides guidance on the circumstances where it would be inappropriate for directors to buy or sell shares. Briefly, it provides that :-

- (a) directors should not deal on the basis of short-term considerations;
- (b) they should in general not deal in the two months prior to the regular announcement of results; and
- (c) if they intend to deal, they should give notice to some other specified member(s) of the board so that they can be advised against the act if a price sensitive development is in prospect.

This does not go as far as the US practice, where directors have a strict liability to disgorge profits on dealings in any six-month period prior to any price sensitive development.

12.16. We recommend that the SEHK should introduce a Code governing securities transactions by directors of listed companies. This would complement the insider trading laws.

Major and related-party transactions

12.17. Rule 6 of the Undertaking between a listed company and the SEHK, prescribed under the Securities (Stock Exchange Listing) Rules, requires a listed company to deliver to the Commissioner for Securities a draft press notice giving brief particulars of any notifiable transaction as soon as reasonably practicable after agreement in principle has been reached and, as soon as practicable thereafter, to cause the notice, as amended to take account of any comment by the Commissioner, to be delivered to the SEHK and published in the newspapers. Briefly, notifiable transactions are defined as : -

(a) any acquisition or disposal of assets by the company, including its subsidiaries, which -

(i) accounts for more than 15% of the company's assets; or

(ii) involves their directors or chief executive; and

(b) any transaction by a subsidiary which is -

(i) a loan or other financial assistance to a parent company;

(ii) a provision of security for the discharge of any obligations of a parent company; or

(iii) other than in the ordinary course of business.

12.18. It was argued in submissions that these requirements do not go far enough and that there is a need generally to tighten the rules and their implementation, because public investors in Hong Kong companies are not in a satisfactory position vis-a-vis managing shareholders, particularly where a company is family controlled. It has been suggested that many Hong Kong businessmen do not distinguish between their own interests and those of their outside shareholders; or, if they do, that they do not sufficiently understand their obligation to put their fiduciary duties first.

12.19. However, it has also been suggested that investors in Hong Kong invest in particular companies precisely because they believe in the business acumen of the managing shareholder and that he can help them by helping himself. It was, therefore, argued that a general tightening up of the rules in this area would not be appropriate in the particular circumstances of Hong Kong's corporate world. We believe that there is some merit in this argument. Nevertheless, we feel that it is anomalous that Hong Kong's major corporate entities should escape international standards in this area when they have a large body of local and international professional and institutional shareholders and are now actively investing and acquiring companies in other countries.

12.20. We recommend therefore that the SEHK should require listed companies to seek shareholders' prior agreement before major transactions, such as large acquisitions or disposals of assets are entered into and to seek independent shareholders' prior approval for transactions in which a director or a substantial shareholder has a material interest(3).

12.21. We have not considered in detail how to define major transactions or material interest. We suggest that, in devising such rules in Hong Kong, the Exchange should study the practice of the International Stock Exchange in London.

(3) The Companies Ordinance, at S.155A, requires such approval for disposals exceeding 1/3 of the company's fixed assets. The problem with this provision is that the threshold is too high and it only refers to fixed assets owned directly by the parent company itself.

CHAPTER XIII

OTHER AREAS

Introduction

13.1. In the foregoing chapters, we have covered in turn the four main areas of our review; we then dealt with a number of other issues which did not fit neatly into the pattern of the previous chapters. In the course of our work, we have also identified a range of issues which require attention. We cover these here. In the time available, we have not considered these issues in detail but they raise important questions which should be addressed by the authorities concerned.

(A) Review of legislation covering the securities industry

13.2. The principal legislation governing the industry, as set out in Appendix 25 above, was enacted over ten years ago. Since then, the securities industry, both locally and internationally, has undergone very significant changes. We believe there is a need to undertake a comprehensive review of the legislation to ensure that it deals adequately with recent market developments and modern trading practices⁽¹⁾. We therefore recommend that the Administration should undertake a thorough review of the legislation governing the securities industry as a matter of urgency.

(1) A number of deficiencies relating to the registration of dealers and advisers and to the marketing of new issues were identified in Chapters X and XI.

(B) Insider trading

13.3. A number of submissions to the Committee argue that the existing approach to insider trading⁽²⁾ in Hong Kong is inadequate. In particular, they feel that the current sanction of a public reprimand is insufficient and advocate tougher penalties to deal with such undesirable practices.

13.4. Originally, insider trading was made a criminal offence under the Securities Ordinance. The provisions were, however, not brought into operation⁽³⁾ and were eventually replaced in 1978 with the present provisions which involve the appointment of an Insider Trading Tribunal by the Financial Secretary to investigate specific allegations of insider trading followed by the publication of a Tribunal's report. While the practice of insider trading is referred to in the Ordinance as culpable, there is no provision for any sanction other than a public reprimand.

13.5. While we have not considered this issue in detail, we note that one of the regulatory objectives we have set in Chapter III is that the market should be fair and offer equal opportunities to all participants. Insider trading undermines the fairness of the system and should be prevented as far as possible.

(2) Insider trading refers to transactions in securities of a corporation by those who are in possession of private information which might have a material impact on the price of the securities.

(3) We understand that the decision not to bring the original provisions into force was based on the view that criminal sanctions would not be effective in preventing insider trading in Hong Kong because it would often be impossible to obtain sufficient evidence to secure a conviction.

13.6. We would, however, point out that the subject is extremely complicated, in particular the definition of an insider, the question of tipper/tippee liability⁽⁴⁾, the distinction between mere possession and misappropriation of price sensitive information etc. Furthermore, the call for tougher sanctions against insider trading should not be regarded as synonymous with a call for its criminalisation. We believe that penalties such as desegregating profits, debarring directorships and freezing voting rights could be effective deterrents. However, as we have not considered the question in detail, we are not in a position to make any recommendations in this regard. We note that work on this area is currently being undertaken by the Administration and urge that this be completed as soon as possible.

(C) The Hong Kong Code on Takeovers and Mergers

13.7. The Hong Kong Code on Takeovers and Mergers is based on the original UK Code of the mid-1960s which has now been substantially revised and up-dated. This has prompted calls from professional advisers for a review. Some have also argued for a Hong Kong equivalent of the UK Rules governing substantial acquisitions of shares (the so-called Dawn Raid Rules), which in broad terms restrict the speed with which a person can increase his shareholding from 15% to 30%; and require accelerated disclosure of share purchases relating to such acquisitions.

13.8. The main focus of concern, however, has been that companies are not willing to comply with the Code. We believe that given the relatively small number of hostile

(4) In the US, any insiders passing on price sensitive information (tippers) and certain persons receiving such information (tippees) may be liable to penalties.

bids in Hong Kong, the issues which are most important in London are not as pressing here. The main problem in Hong Kong appears to be non-compliance with the requirement for a general offer once a shareholding exceeds 35%. In this respect, it has been suggested that the sanction of a public reprimand has not been sufficient to enforce the Code.

13.9. We are of the view that the general offer requirement is fundamental to ensuring broad equality of treatment for all shareholders. The question of whether a breach of the Code should be made a criminal offence and the sanction for such a breach is, however, vexed. Different major markets have adopted different approaches. In the time available, we have not considered the question in sufficient detail to make detailed recommendations.

13.10. We recommend that the new Securities Commission should review the Hong Kong Code on Takeovers and Mergers concentrating on :-

(a) general housekeeping improvements;

(b) the administration of the Code; and

(c) the enforcement provisions and the sanctions backing the Code.

Moreover, the review should not simply opt for incorporating the new UK provisions but should consider the main issues that arise in the light of the particular nature of Hong Kong's corporate finance market.

13.11. Before we leave the subject, we wish to draw the Administration's attention to one particular point. We believe that, whatever the merits of the post-crash temporary waiver of the trigger point and creeper provision

(5) of the Code, such ad hoc departures from a fundamental principle create undesirable precedents and, in the long term, tend to undermine the credibility of the entire body of rules. We are of the view that if the situation demanded such an initiative, it would have been preferable to introduce a relaxation similar to the treasury stock rule applied in the US, i.e. to allow companies to purchase their own stock for retirement. Such a move, while offering similar possibilities to the action taken in the aftermath of the October crash, would have benefitted all shareholders to an equal degree. In any case, we recommend that the Administration should favourably consider the merits of introducing a treasury stock rule in Hong Kong.

(D) Margin trading

13.12. Another area which requires urgent attention is the regulation of margin trading by members of the Stock Exchange of Hong Kong (SEHK). The submissions alleged that some brokers have been allowing 100% margins to clients and that unrealised profits on margined shares are accepted as security for further margin trading. While we acknowledge that this did not create any serious difficulties for brokers in the events of October 1987, it has been suggested to us that this was because the market closed

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- (5) Under the Hong Kong on Takeovers and Mergers Code, any person with 35% or more of the voting rights of a company (the trigger point) and any person with between 35% and 50% who acquires more than an additional 5% of the voting rights within any 12-month period (the creeper provision), must bid for the entire share capital of the company. On 26 October 1987, the Commissioner for Securities announced a one-month waiver of these two provisions subject to full disclosure and a requirement to place out the additional shares within 12 months.

giving clients and their brokers time to make the necessary arrangements. In this regard it should be noted that, when the market re-opened on 26 October 1987, the Commissioner of Banking made a statement to the effect that he hoped banks and deposit-takers would adopt a constructive approach towards borrowers with facilities used to finance securities holdings, commenting that enforced disposal of securities by bank customers to meet margin requirements would exacerbate the pressures on the markets.

13.13. We believe that this subject deserves urgent attention. At the moment, there are no regulations governing minimum margin levels, the types of security accepted as margin deposits, the extent of margin trading conducted by a client or a broker and the rates of interest charged to clients. There are also no rules requiring such trades to be marked to market daily. The lack of regulation creates significant risks for brokers and clients.

13.14. Quite apart from the risk to brokers of unregulated margin trading, we believe that, in the absence of regulation, opportunities for over-trading exist and that this contributed to the over-heating of the market in the run-up to the October crash. We therefore recommend that the SEHK should, in consultation with the new Securities Commission, promulgate rules to govern margin trading and should regularly publish the extent to which trading in each stock is financed by margin lending.

13.15. We further suggest that, pending the promulgation of rules governing margin trading, the Exchange's surveillance team should pay particular attention to this area to ensure the financial integrity of the players, both brokers and clients, in the market.

(E) The role of trade associations

13.16. While the primary focus of the regulatory strategy which we mapped out in Chapter III is on the two Exchanges, we believe that representative trade associations have a complementary role in advancing self-regulation. Such associations are usually alert to market needs and are in a good position to contribute to the formulation of policy and the development of rules. They can also help promote the industry and upgrade practitioner standards.

13.17. We identified, in previous chapters, certain functions for trade associations. On the listing of securities, we supported the formation of industry bodies to represent the issuing houses and institutional investors. On the development of codes of conduct for the protection of investors, we proposed that trade associations such as the Hong Kong Stockbrokers Association should play a leading role. Similarly, we believe that other industry bodies such as the Hong Kong Unit Trust Association and the Hong Kong Capital Markets Association have an important role to play in developing policies and practices in their respective areas. We believe that the authorities should encourage their further development by involving practitioners collectively in the formulation of policy and consulting them where appropriate. Given Hong Kong's strong tradition of government by consensus, we are sure that such a participative approach to policy making will be well received.

13.18. Our experience in conducting this review has clearly demonstrated practitioners' willingness to contribute. We hope that the new Securities Commission will keep the impetus going by actively encouraging greater industry participation in the development and regulation of the market.

(F) Second market

13.19. In June 1987, the SEHK submitted to the Commissioner for Securities a formal proposal for the establishment of a second market for securities in Hong Kong. The proposed entry criteria are at Appendix 31.

13.20. A Working Party of the Hong Kong Association of Banks set up to look at venture capital in Hong Kong also concluded in its Report published in June 1987 that a second market for securities should be established to further stimulate the venture capital industry in Hong Kong. The Working Party also recommended that listings on the second market should primarily be companies engaged in manufacturing industry.

13.21. Opinions in the submissions to the Committee on whether a second market should be established in Hong Kong are divided.

13.22. The arguments in support of a second market are :-

(a) it would stimulate the supply of venture capital to meet the demands of young innovative enterprises; and

(b) it would encourage China-related companies to seek a listing in Hong Kong as generally speaking these companies do not have the requisite track record to secure a listing on the SEHK.

13.23. The arguments against a second market are : -

(a) there is no demonstrable need : capital raising through equities is not the

primary route for the manufacturing industry;

(b) a second market with lower entry requirements could lead to the admission of poor quality stocks which is undesirable in terms of investor protection; and

(c) the Exchange's management, in particular its listing arrangements, would need to be substantially improved before a new market is developed.

13.24. We suggest that plans to establish a second market should be deferred until the current reforms of the Exchange's listing arrangements have been completed. In any case we are concerned that if a second market is developed, it should not be a second rate market, with companies listed being subject to lower standards of disclosure and surveillance.

(G) Insurance coverage for Exchange members

13.25. In the course of our work, we also considered the desirability of compulsory insurance coverage for members of the SEHK and the Hong Kong Futures Exchange (HKFE). We believe that it would be appropriate to introduce such a scheme to cover brokers and their clients against errors, omissions and fraudulent acts by brokers' staff. Apart from providing better protection for the investor, insurance coverage would introduce a further element of discipline to the market. This is because the insurer would provide additional surveillance over the Exchanges and their members. For example, in the International Stock Exchange in London, the insurer pays for additional

surveillance by a team of six independent specialists who are auditors conversant with risk control in financial institutions. Furthermore, as the insurers would have to be satisfied with the controls put in place by the Exchanges and their ability to manage the markets and their members prior to agreeing the insurance coverage, the scheme would effectively provide an independent seal of approval for the Exchanges and their systems. This should contribute significantly to restoring confidence in the Hong Kong market. We therefore recommend that the concept of insurance coverage for members be pursued further by the Exchanges and the new Securities Commission.

(H) Brokers' commission

13.26. We have received conflicting views regarding the present minimum level of brokers' commission, presently at 0.25% of the value of the transaction. Some have argued that the level should be raised to improve the viability of the small local brokers and enhance the quality of services provided; others have argued for the abolition of the minimum level to allow free competition. We have not examined the question in detail and suggest that the subject be reviewed in connection with the overall review of legislation governing the securities industry suggested earlier.

(I) Compensation Fund

13.27. The legislation currently provides for compensation funds for investors in the event of brokers defaulting on the SEHK and HKFE. The maximum contribution is set at \$100,000 per broker and the respective sizes of the Compensation Fund for the SEHK and HKFE are \$48.7 million and \$34.7 million. The funds are administered by

the Office of the Commissioner for Securities and Commodities Trading (OCS). A number of submissions have argued that the funds are insufficient and should be raised. We suggest the Administration examine the merits of the case further. This would be best covered under the comprehensive review of securities legislation advocated earlier.

(J) Developing the Hong Kong debt market

13.28. This report has concentrated on Hong Kong's markets in equities and the derivative product, stock index futures. In Chapter III, we stressed the importance of steps being taken to develop Hong Kong's other capital markets.

13.29. The main candidate is the debt market. The only substantial markets in Hong Kong are in commercial paper (CP) and certificates of deposit (CDs). Both markets have developed rapidly in recent years: in the year to December 1986 total secondary market CD trades by banks and DTCs increased more than threefold. Although activity is largely restricted to short-term paper, there is considerable interest in the debt markets. Perhaps partly reflecting this, the Hong Kong Capital Markets Association was established in 1987 and now has over 100 members. A brief survey of Hong Kong's non-equity markets conducted by the Association on our behalf showed that, out of 58 respondents, around 30 firms stated that they were active both as principals and agents in the Hong Kong dollar capital market. A similar number indicated material activity in foreign currency issues.

13.30. We found that there were fairly widespread concerns amongst the major players about the market's lack of depth and breadth and its future development. It was

argued that Hong Kong's financial markets offered a relatively narrow range of investments, with too much emphasis on banking and equities. This impaired the quality of the market in a number of respects.

13.31. First, it limits the activity here of some of the world's major bond market houses. Second, it reduces the ability of Hong Kong companies to structure their balance sheets flexibly without going overseas. Third, it constrains the ability of Hong Kong investors to achieve a properly balanced portfolio without looking overseas. This is particularly important for retirement and life insurance funds which have long-term Hong Kong dollar liabilities.

13.32. In explaining the lack of a debt market, intermediaries suggested that there were a number of regulatory impediments. First, the requirement for Securities Commission approval of individual CP issue was said to be cumbersome and lengthy. Second, the minimum denomination requirement of \$500,000 for CP issues had the effect of excluding retail investors from the market. Third, there were severe fiscal obstacles. The 15.5% withholding tax imposed on CP interest payments to retail investors is a further impediment to retail investors entering this market given that a similar tax is not imposed on interest on deposits with banks. Moreover, the 17% profits tax paid by corporate investors on interest income earned onshore was a deterrent to their purchasing local debt instruments.

13.33. The burden of the complaint therefore was that the Hong Kong debt market is artificially narrow on account of supervisory and tax regulations which act as disincentives to investment by individuals and non-financial corporations.

13.34. In response it has been pointed out that there may be fundamental reasons for the lack of a debt market. For example, retail investors may be put off by the low yield and absence of opportunity for capital appreciation as compared with equities; and the low liquidity compared with bank deposits. Secondly, it is suggested that the range of potential issuers is narrow and could not support a market, especially given the lack of regular Government issues and the benchmark prices they would provide.

13.35. However, irrespective of the validity of this scepticism about market potential, it does not of itself constitute a case for preserving the alleged regulatory obstacles. We believe that the development of a healthy debt market would enhance Hong Kong's attractions to investment managers and enhance its status as a regional fund management centre. Moreover, it would be in line with our suggestion in Chapter III that Hong Kong should aim to be the primary capital market for South East Asia.

13.36. As stated in Chapter III, we believe that, as a general principle the development of financial markets should be as free from constraints as is consistent with prudent development and the protection of investors and that, in particular, such development should not be impeded by regulations designed to maintain structural or institutional features of the marketplace for their own sake. We, therefore, support the contention that the market should be allowed to determine Hong Kong's level of interest in debt.

13.37. We recommend :-

- (a) that the Administration should have the objective of stimulating and sponsoring

the development of debt markets in Hong Kong; and

- (b) to that end should review the regulation of debt markets and remove any unnecessary impediments to its development.

(K) Market linkages

13.38. So far our report has divided securities industry regulation into stock market issues and futures market issues, and has considered both in isolation from other financial market questions. In practice, however, such neat compartmentalisation does not exist. As the US Brady Task Force said : -

".... what have been traditionally seen as separate markets - the markets for stocks, stock index futures, and stock options - are in fact one market They are linked by instruments, participants, trading strategies and clearing flows."(6)

13.39. This statement applies equally to Hong Kong. Last October, developments in the stock market directly affected the course of events in the futures market which, through the overhang of large long arbitrage positions, in turn threatened further stock market falls(7). Moreover,

(6) Report of the Presidential Task Force on Market Mechanisms, Chapter Six, January 1988.

(7) See para. 6.38.

the impact was not contained to the securities markets. As we reported above, the Commissioner of Banking felt a need to urge calm amongst banks which had lent against equity collateral.

13.40. As we see it, market linkages raise five questions for Hong Kong : the asymmetry in the Hang Seng Index (HSI) futures market, margin requirements, trading halts, clearing and surveillance arrangements and the introduction of new derivative products.

Asymmetry in futures market

13.41. As explained in Chapter V, short selling is illegal on the SEHK. The effect of this as regards the stock index futures market is, first, that firms do not take long futures positions to hedge short stock positions. Secondly, short arbitrage is effectively ruled out. This has probably not mattered in the past because the market was in a strong bull phase. But in dull, bearish or perhaps even normal markets, the futures contract can be expected to fall to a discount to its theoretical level from time to time. In the absence of arbitrageurs, the two markets could decouple.

13.42. As already stressed in Chapter V, the introduction of short selling should remove the asymmetry in the futures market and enhance market linkages. However, subjecting short selling to an "up-tick" or "zero-tick" rule⁽⁸⁾ might place obstacles in the way of arbitrage in falling markets, as there would not be any "up-ticks". This should be considered carefully when controls on short selling are addressed.

(8) See Chapter V for an explanation of their rules.

Margins

13.43. As discussed in Chapters VI to VIII, futures contracts are subject to margin requirements set by the HKFE and the clearing house, the ICCH (HK). Margin trading in the stock market is not subject to rules but is widely practised in Hong Kong. We understand that brokers typically collect margin not on the trade date but on the settlement date and that accounts are quite often never completely and finally settled; rather the client continues to trade on margin with further cash calls being made if prices fall significantly. This is fairly near to trading on margin in the futures market, except that futures margins are lower.

13.44. At present the ICCH (HK) sets a margin level of 15% for the HSI contract, whereas we were told that the accepted prudent level for stock market margins in Hong Kong was 50% for individual index constituents, but less for a diversified portfolio. The difference raises the question as to whether the respective margin requirements should be equalised. This is in practice a call for higher futures margins. Those in favour of equalised margins argue that they are necessary to prevent markets getting out of balance and that futures market margins are simply too low, creating the risk of a speculative bubble based on highly leveraged positions. They maintain that this would not damage the market since a fundamentally sound futures market should thrive through the customer base being different, the depth to the market provided by the contract date system and the availability of reliable prices where arbitrage is efficient.

13.45. Opponents to this line of thinking argue inter alia that, as a matter of practice, the futures market margining system has worked and, in particular, that clearing houses and brokers have not collapsed (pace Hong

Kong, where the margins were not collected); that futures margins and stock margins are fundamentally different, the first constituting collateral and the second a part-payment; and that futures margins should be lower because an index representing a diversified portfolio is less volatile than individual securities.

13.46. It seems to us that the two types of margin serve fundamentally the same function for the broker-dealer in so far as both are collateral designed to protect brokers against losses through an adverse price movement in the event of a client defaulting.

13.47. We believe that, in this sense, the two sets of requirements can be regarded as broadly equalised if they adequately protect against losses in their respective markets. The emphasis, therefore, should be on ensuring that the requirements sufficiently reflect the different circumstances of each market and are adequate to prevent major credit failures. So long as the margin requirements are prudentially adequate, we would not be disturbed on micro-prudential grounds if this results in greater leverage in one market. The priority in Hong Kong is to ensure that futures margin requirements are enforced and that, as recommended earlier in this chapter, rules are introduced governing minimum levels of margin for the stock market.

13.48. Given the lax credit extension in the past it is imperative for the Exchanges to ensure that margin levels are prudentially adequate. To protect against their falling down on the job, we recommend that in case of urgent necessity the new SC should have a reserve power to set minimum margin requirements for either or both markets.

13.49. Some people have raised the broader question of whether margin requirements should be used as a macro-economic tool to ration the provision of credit to the securities industry. But this is not a matter for us.

Trading halts

13.50. Many markets around the world apply trading halts if prices move abruptly or if conditions are disorderly. In Hong Kong, the HKFE operates a limit down/up system whereby trading ceases for a period if prices move by a specified amount; this currently applies only in the first and second month contracts and not in the spot month.

13.51. The SEHK does not operate a system of trading halts dependent upon price movements but it does suspend trading in individual stocks if disorderly conditions develop. This might occur in fast markets because volumes might exceed the capacity of the trading system or, in the absence of market-makers with firm obligations to stand in the market at all times, severe order imbalances could occur. Whether either would have happened if the SEHK had stayed open last October will never be known. Finally, of course, the Exchange might shut the market, as did happen in October 1987.

13.52. In principle we are opposed to trading halts; markets should at all times be available to investors and should be allowed to adjust spontaneously to news and developments. However, we would not dispute that severely disorderly conditions can develop where a pause for digestion might be desirable. Traders should so far as possible know what will happen in such circumstances.

13.53. Any halt should, however, be a pause. The market should not automatically close for the remainder of the

morning or afternoon session. As we argued in Chapter V, stock suspensions should be brief. Similarly, we believe that, if the futures market goes limit up or down, trading should be suspended for as short a time as seems prudent to the Exchange authorities in the circumstances. The objective should be to resume trading as quickly as possible.

13.54. But, in terms of market linkages, the key is co-ordination between the two Exchanges. For example, if trading is suspended or delayed in a significant proportion of index components on the cash market, it will be appropriate to suspend trading in the index futures contract as reliable prices will not be available to compute the value of the underlying index. Similarly, if futures volumes are very high and there is a large amount of arbitrage or other strategies linking the markets, there will be a case for suspending the stock market if the futures market halts. This may require the HKFE to review its current limit up/down system to ensure that trading halts are rare, occurring only in disorderly markets. But above all, it entails extensive co-ordination between the two Exchanges at executive staff level.

13.55. While the course of action that is required will depend on individual circumstances, some basic ground rules should be in place. We firmly recommend that the SEHK and HKFE should produce ground rules, which should be discussed with the regulatory authority, as to procedures for notification of developments in their respective markets and as to arrangements for making a co-ordinated response to disorderly trading, with the objective of ensuring smooth and predictable linkages.

Co-ordinated clearing and surveillance

13.56. Ideally, the mechanics of the clearing and settlement systems for the stock and futures markets should interlock; so that, for example, the cash flows of a hedged position are symmetrical; at present, a hedger liable to pay extra margin on account of losses in the futures market might have to rely on borrowing against the security of unrealised stock market gains.

13.57. Unified clearing is a long way off and the first priority for Hong Kong must be to strengthen the arrangements in the futures market and to develop a robust central clearing system for the equity market. However, it is imperative that there is close co-operation and information sharing amongst the clearing houses and their respective Exchanges regarding common and related members. This should be taken into account in the development of the two systems. In particular, we recommend that in due course machinery should be established to ensure that the senior management and surveillance staff of the two Exchanges and their respective clearing agencies co-ordinate properly and fully; and further that there should be no obstacles to a proper and full exchange of information. In the short run, the futures market clearing house should have a line into the SEHK on these matters.

The development of new derivative markets

13.58. Hong Kong currently has only one stock derivative product, the index futures contract market. We have heard proposals, however, for the launch of options⁽⁹⁾ on

(9) An option is an agreement whereby the purchaser has a right to sell or to buy a particular commodity at a specified price from the person who provides the option.

individual stocks, options on the HSI and options on the existing HSI futures contract⁽¹⁰⁾. Indeed, it has been suggested that many investors in futures believed that, in fact, they were purchasing a limited risk option.

13.59. We would stress that the market linkage issues raised above apply equally to options and indeed would be even more complex as a result of there being more markets. If the possibility of introducing options trading in Hong Kong is pursued, the ground rules should be laid very carefully.

13.60. To sum up, we believe that it is essential that the two Exchanges, the regulatory authority, the Commissioner of Banking and the Monetary Affairs Branch develop an understanding of the linkages between the stock and futures markets and their impact on banks, money markets and payment systems. Moreover, it is imperative that these bodies develop adequate and regular liaison arrangements to ensure that problems which cross institutional boundaries are picked up by all the parties concerned and dealt with at an early stage.

(L) Supervision of diversified firms

13.61. In addition to market linkages, a host of important issues are raised by the growth of diversified financial services conglomerates and the increasing tendency for firms to be active in different geographical areas and financial centres. Some of these are discussed below.

(10) We understand that the first two would require legislation but that options on futures are already contemplated by the Commodities Trading Ordinance.

Functional versus institutional supervision

13.62. The basis of many of our recommendations is that, while the statutory regulator should set minimum entry standards and capital adequacy requirements, the two Exchanges should be responsible for the day-to-day surveillance of their members⁽¹¹⁾, including compliance with their own rules, SC rules and statutory requirements. The futures market clearing house and, in the future, any equity market clearing agency would play a central part in the process on account of their receiving daily information on positions and cash flows etc.

13.63. As many firms are active in other markets⁽¹²⁾, both here and overseas, it is essential that, in assessing a member's financial position, the SEHK, the HKFE and the associated clearing houses should look beyond the business conducted on their trading floors, because a member might get into difficulties or even fail because of losses incurred in its non-Exchange business.

13.64. More generally, the Exchanges and the new SC should adopt institutional supervision not functional supervision, as it is legal entities, not functional divisions or parts of legal entities, which become insolvent.

(11) Non-members would be subject to direct SC supervision.

(12) Individual SEHK members are not restricted as to their range of activities. The effect of SEHK Rule 302(4) is that a corporate broker may carry on business which is "normally ancillary to a stockbroking business". Under S.17 of the Commodities Trading Ordinance, a shareholder of the HKFE may trade in commodity futures in other markets.

13.65. We appreciate that this will not be straightforward as, although non-Exchange business should show up on monthly and quarterly financial reports, the Exchanges' surveillance staff and the clearing houses will not see the non-Exchange business on a day-to-day basis. The SEHK and HKFE must therefore establish relations with other market authorities and supervisors to ensure that they would be warned if one of their members was experiencing difficulties; for example, the futures market clearing house should be confident that it will be told by clearing houses elsewhere in the world if a HKFE member has defaulted on a margin payment. It is equally important that there should be reciprocal arrangements, with warnings going out from the Exchanges and clearing houses, if they detect problems with a Hong Kong dealer.

Dual authorisation and supervisory overlap

13.66. A second set of issues concerning the need to supervise the overall financial position of an institution arises where firms conduct a range of activities that are regulated under different statutes by different supervisory bodies. The best example in Hong Kong is the involvement of banks in the securities industry⁽¹³⁾. This has raised questions about whether such institutions should be subject to dual authorisation and how they should be supervised. One particular problem is that, because of the different dynamics of banking and securities trading, the supervisory requirements can be quite different; for example, bank supervisors use a narrow definition of eligible capital instruments but are flexible in the

(13) A survey conducted in Spring 1987 by the Commissioner of Banking showed that over a quarter of authorised deposit-taking institutions had some involvement with securities dealing, a few substantially so.

application of the ratio requirements from day to day; whereas securities regulators tend to use a wide definition of eligible capital instruments but apply harsh risk requirements which must be strictly satisfied at all times. It can be difficult for a firm to satisfy both sets of requirements.

13.67. The Hong Kong authorities have sought to tackle this problem with an administrative agreement whereby licensed banks and deposit-taking companies (DTCs) are generally granted exempt status by the OCS and are supervised by the Commissioner of Banking. However, the OCS retains responsibility for ensuring that DTCs which are registered securities dealers comply with all the other requirements imposed on registered dealers, such as the segregation of clients' moneys.

13.68. As already explained in Chapter X, we consider that the current position is unsatisfactory. We believe that a bank or DTC which carries on a securities dealer's business should be required to become an authorised securities dealer and, with the exception of financial requirements, should have to comply with the regulatory authority requirements designed to protect clients. However, we also believe that only one regulatory body can sensibly supervise an institution's financial position and, in particular, that two sets of potentially incompatible ratio requirements should not be imposed. We therefore proposed in Chapter X that, wherever possible, the Commissioner of Banking should be responsible for the financial supervision of entities which have dual authorisation as a bank/DTC and a securities dealer. This delegation of financial surveillance could be achieved in a number of ways.

13.69. We believe the modalities are a matter for the two bodies directly concerned and the Administration which might need to legislate on the matter, although we would stress that the arrangements should be easy to understand. In addition, it is essential that proper information gateways should exist to enable full and frank co-operation at all times.

13.70. It is important that, if the Commissioner of Banking is to be responsible for the financial adequacy of some securities firms, he should capture the risks involved in securities trading and distribution in his supervision and ratio requirements. In particular, he should take account of position risk. This raises the thorny issue of level playing fields; although banks and securities firms tend to be subject to different ratio requirements, it is important that, where appropriate, the effect should be broadly consistent for similar activities.

Consolidated supervision

13.71. A similar set of issues arises in relation to diversified financial groups. A single group may be involved in all of, say, securities, futures, investment management, insurance and banking through a series of separate subsidiaries which are individually authorised and supervised by different regulatory bodies. At the least, this entails close co-operation and information sharing by the various supervisors in Hong Kong. In particular, in the event of a default on one of the two Exchanges, its executive staff should notify their opposite numbers. This is important not just because of possible knock-on effects, but also because most major losses occur through imprudence (for example, allowing the build up of large risk concentrations) and in our view poor management is likely

to be prevalent in other part of the group. However, ad hoc contact on particular problem cases will not be enough to ensure that the regulators can take into account the overall position of a group. We therefore recommend that arrangements should be put in place to ensure that regulators collectively have an overall view of a diversified group's financial position.

International co-operation

13.72. In this connection, it is important to keep in mind the international dimension of Hong Kong's markets and the supervisory issues it raises. Many of the firms active in Hong Kong have extensive operations in other centres. Some have parent companies overseas and a few can be regarded as global businesses. Problems arising elsewhere could have knock-on effects in Hong Kong. Similarly, problems in Hong Kong might impact on operations elsewhere and will certainly be of interest to overseas supervisors and, where relevant, parent companies.

13.73. It is essential that the Hong Kong regulators and the Exchanges should take this into account in their supervision of local business with overseas outlets and foreign businesses with an operation here. The range of problems will vary from case to case, but all can to some extent be addressed through bilateral contacts with overseas supervisors and market bodies. Further than that, Hong Kong must continue to contribute at all levels to the growing international debate as to how best to regulate geographically diversified securities businesses and groups.

(M) A Financial Services Commission

13.74. The broad conclusion of the previous two sections is that it is essential that there should be close co-operation and co-ordination between supervisors, domestically and internationally, to ensure that regulatory requirements are compatible; the overall soundness of financial service groups is properly assessed; inter-market links are understood and supervisory resources are not wasted by duplication of effort.

13.75. But the developments and issues identified above also raise the question as to whether Hong Kong should establish one umbrella supervisory body for the financial services sector as a whole, bringing together some or perhaps all of securities, futures, banking and insurance regulation, and maybe even company and accounting matters as well. This proposal was made in some submissions.

13.76. By taking this route, Hong Kong would be leapfrogging other major financial centres by doing now what many believe they will probably have to do sooner or later. A number of countries have already taken significant steps in this direction; for example, Japan's Ministry of Finance covers, inter alia, banking and securities; the Singapore regulators cover securities, futures, banking and insurance; Australia's National Commission for Securities and Companies is responsible for securities and company law and accounting issues.

13.77. There is much to be said for this idea. However, we believe that, as far as Hong Kong is concerned, the need has not been conclusively demonstrated. First, the markets here do not yet seem to be as integrated as elsewhere; in particular, there is a numerous body of securities market specialists, especially amongst the local broking

community. Secondly, we believe that, in the short run, the existing fragmented structure may be optimal in terms of ensuring that each agency sticks to its specific task and in particular, that any new securities industry regulator concentrates entirely on improving the quality of securities market regulation. Having said that, we believe this is an important issue which will not go away and that the Administration and the various regulators should keep it under review.

13.78. We believe, however, that some machinery will be needed to ensure proper co-ordination. We therefore recommend that a Co-ordinating Committee should be established to co-ordinate policy, exchange ideas, and ensure broader public policy considerations are weighed etc.

13.79. This would be a committee of office-holders and as such would not need any formal existence. It should be chaired by the Financial Secretary in order to ensure the appropriate level of seniority in representation and to avoid its becoming bogged down in detail. Members would include the Secretary for Monetary Affairs, the Chairman of the new SC, the Commissioner of Banking and the Registrar General. The group's function would be to identify potential turf disputes and ensure they were resolved. It would not attempt to deal with them itself and for that reason, would probably not need to meet more than a few times a year. The resolution of policy issues would be handled on an ad hoc basis.

APPENDIX 1

THE CLOSURE AND SUBSEQUENT EVENTS

On Monday, 19 October 1987, following three successive days' decline on the New York stock market, which saw 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.

2. 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 -

<u>Index</u>	<u>1987 Peak</u>	<u>Date</u>	<u>Level on that date in 1986</u>	<u>Percentage increase in 12 months</u>
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%

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 (1). Turnover had almost trebled during the period.

3. 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.

(1) Base date for the HSI : 31 July 1964 at 100 points.

4. 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 (2). 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.

5. 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).

6. 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).

7. 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 (3). The Chairman pointed out that

(2) 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.

(3) 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.

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.

8. 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 (4).

9. 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 \$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.

10. 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.

11. 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.

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

12. 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).

13. 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.

14. 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) (5).

15. 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.

(5) Subsequent returns provided by the arbitrageurs showed that these undertakings were honoured.

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

17. To enable the FGC to meet its obligations, arrangements were made that evening to provide an additional \$2 billion support facility (6), comprising \$1 billion from the Exchange Fund, and \$1 billion from 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.

18. 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.

19. 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.

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

21. 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.

22. 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.

23. 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

(6) This facility expired on 26 April 1988 without having been drawn down.

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.

APPENDIX 2

MEMBERSHIP OF THE SECURITIES REVIEW COMMITTEE

Mr Ian Hay DAVISON (Chairman)
Mr S L CHEN, CBE, JP
Mr LAU Wah-sum, JP
The Honourable Peter POON Wing-cheung, MBE, JP
Mr Charles SOO
Mr Philip TOSE
Mr Michael WU (Secretary)

APPENDIX 3

REPRESENTATIONS RECEIVED

The following is a list of bodies, companies and individuals who submitted representations in response to the Securities Review Committee's announcement on 23 November 1987 inviting submissions on all aspects of the Committee's work : -

Bodies (including those which are the subject of the Committee's review)

The Association of The Institute of Chartered Secretaries & Administrators in Hong Kong

City Polytechnic of Hong Kong, Department of Business and Management

Commodities Trading Commission

The Hong Kong Association of Banks

The Hong Kong Capital Markets Association

HK Economic Research Centre

Hong Kong Futures Exchange Ltd.

The Hong Kong Futures Guarantee Corporation Limited

The Hong Kong General Chamber of Commerce

Hong Kong Society of Accountants

The Hong Kong Society of Security Analysts Limited

Hong Kong Stockbrokers Association Ltd.

Hong Kong Unit Trust Association

Hong Kong Venture Capital Association Limited

I.C.C.H. (Hong Kong) Limited

The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited

The Law Society of Hong Kong

Life Insurance Council of Hong Kong

Securities Commission

The Stock Exchange of Hong Kong Ltd.

University of Hong Kong, Department of Management Studies

Companies

A group of international securities firms

Arthur Andersen & Co.

Asian Oceanic Limited

Barclays Bank PLC

Barclays de Zoete Wedd Securities (Asia) Limited

Baring International Asset Administration Limited

Baring Securities (Hong Kong) Limited

Central Registration Hong Kong Limited

ChinTung Holdings Limited

Chuangs & Co.

Citibank

Citicorp International Limited

Coopers & Lybrand

County NatWest Investment Management Asia Limited

County NatWest Securities Asia Limited

Crosby Securities (HK) Limited

Deutsche Bank (Asia) Hong Kong Branch

East Asia Warburg Ltd.

F.P. Special Assets Limited

F.R. Zimmern Ltd.

Financial Engineering Corp. Ltd.

G.T. Management (Asia) Limited
Gibson, Dunn & Crutcher
Griffiths Management Limited
Hambro Pacific Limited
Heath Fielding Insurance Broking Limited
Hoare Govett Asia Limited
The Hongkong and Shanghai Banking Corporation
Hsin Chong Holdings (H.K.) Ltd.
IBI Asia (Securities) Limited
Indosuez Asia Limited
James Capel (Far East) Limited
Jardine Fleming Investment Management Limited
Jardine Fleming Securities Limited
Kaiser Stock & Share Co.
Koo & Company
Merrill Lynch Hong Kong Securities Limited
Ming Fung Bullion Co., Ltd.
Morgan Grenfell (Hong Kong) Limited
Morgan Grenfell International Fund Management Limited
Morgan Stanley
Nomura International (Hong Kong) Ltd.
Nomura Research International Co., Ltd.
Poon & Cheung, Solicitors
Robert Fleming Securities Limited
SBCI Securities (Asia) Limited
S.G. Warburg Securities (Far East) Ltd.
Samuel Montagu & Co. Limited

Schroders Asia Limited
Search Financial Services Ltd.
Shearson Lehman Brothers Asia Holdings Inc.
Smith New Court Far East Ltd.
Societe Generale, Hong Kong Branch
Spicer and Oppenheim
Standard Chartered Asia Limited
Standard Chartered Bank
Sun Hung Kai & Co. Limited
Swire Pacific Ltd.
W.I. Carr (Far East) Limited
Wah Ying & Company
Winfull Laing & Cruickshank Securities Ltd.
Wocom Securities Limited
The Wyatt Company (H.K.) Limited
Yamaichi International (H.K.) Ltd.

Individuals

CHAN, Peter P.F.
CHOI Chin Shan
CHOW, Peter K.N.
CHOU Wai Man
Farmer, Peter
FONG, Henry Yun Wah, MBE, JP
Gallie, R.T.
HO Hok Lin
HO Lok Sang

Jordan, D.J.

LAM, Keith H.K., JP

LAW, Passe Pak Hong

McClean, John

Phenix, Paul

Phillips, Peter F.

Pirie, Nicholas

POON H.K.

SHUM, Lina Sui King

Sulke, W.M., OBE, JP

Thorpe, Phillip

TO Hoi Hung

Willoughby, Peter G., JP

WONG Wai Hang

WONG Wai Sun

WONG Yue Tak

YUNG Yau

Government Departments

Commissioner of Banking

Commissioner for Securities and Commodities Trading

Registrar General

Secretary for Monetary Affairs

APPENDIX 4

OVERSEAS INSTITUTIONS VISITED BY THE SECURITIES REVIEW COMMITTEE

UNITED KINGDOM

Bank of England

International Stock Exchange of the United Kingdom and
the Republic of Ireland

The Securities and Investments Board

London International Financial Futures Exchange

The Securities Association

Association of Futures Brokers and Dealers

International Commodities Clearing House

Warburg Securities

PostTel

Institute of Economic Affairs

USA

Chicago

Chicago Mercantile Exchange

Chicago Board of Trade

Chicago Board of Trade Clearing Corporation

National Futures Association

Midwest Clearing Corporation

Midwest Securities Trust Company

Washington

Securities and Exchange Commission

Commodities Futures Trading Commission

General Accounting Office

New York

New York Stock Exchange

New York Futures Exchange

Federal Reserve Bank of New York

National Securities Clearing Corporation

Depository Trust Corporation

JAPAN

Japanese Securities Dealers Association.

Securities Bureau, Ministry of Finance

Tokyo Stock Exchange

Nomura Securities Company Limited

Maruso Securities Co. Ltd.

SINGAPORE

Singapore International Monetary Exchange Ltd.

The Stock Exchange of Singapore

Citicorp Scrimgeour Vickers

Summit Securities

N.M. Rothschild & Sons

Monetary Authority of Singapore

FRANCE

M.A.T.I.F.

AUSTRALIA

Sydney Futures Exchange

Australian Stock Exchange (Sydney) Limited

Australian Stock Exchange (Melbourne) Limited

National Companies and Securities Commission

APPENDIX 5

OVERSEAS ORGANISATIONS NOT VISITED BY THE COMMITTEE WHICH HAVE ASSISTED ITS WORK

Canadian Depository for Securities Limited

Stockholm Stock Exchange

Australian Stock Exchange

Arthur Andersen & Co.

Hong Kong Government Office, Washington

British Embassy, Tokyo

Euroclear

Cedel

Compagnie des Agents de Change, Paris

APPENDIX 6

TECHNICAL DISCUSSIONS

The following firms, associations and individuals were invited to attend technical discussions with the Securities Review Committee : -

Members of the Hong Kong Stockbrokers Association
(three group discussions attended by individual brokers, corporate brokers and brokers who also trade on the Hong Kong Futures Exchange)

Arthur Andersen & Co.

Central Registration Hong Kong Limited

Citicorp International Limited

Coopers & Lybrand

G.T. Management (Asia) Limited

Gibson, Dunn & Crutcher

Heath Fielding Insurance Broking Limited

Hongkong and Shanghai Banking Corporation

Hong Kong Society of Security Analysts Limited

Jardine Fleming (Securities) Limited

Law Society of Hong Kong

Mr Keith H.K. LAM, JP

Mr Derek Murphy

Mr Paul Phenix

Mr Peter F Phillips

APPENDIX 7

FORMAL MEETINGS

The following bodies attended formal meetings with the Securities Review Committee : -

The Stock Exchange of Hong Kong Limited

The Hong Kong Futures Exchange Limited

The Hong Kong Futures Guarantee Corporation Limited

I.C.C.H. (Hong Kong) Limited

Securities Commission

Commodities Trading Commission

Secretary for Monetary Affairs

Commissioner for Securities and Commodities Trading

Hong Kong Association of Banks

Hong Kong Unit Trust Association

Hong Kong Stockbrokers Association

Hong Kong Society of Accountants

APPENDIX 8

COMPARISON OF WORLD'S MAJOR EQUITY MARKETS

(as at end December 1987)

<u>Exchange</u>	<u>Number of listed companies</u>			<u>Total market capitalisation</u>	<u>Total turnover value</u>
	<u>Domestic</u>	<u>Foreign</u>	<u>Total</u>	<u>US\$ billion</u>	<u>US\$ billion</u>
Tokyo	1532	88	1620	2,726	1,758
New York	1577	70	1647	2,132	1,889
London	2061	597	2658	680	317
Germany ⁽¹⁾	507	212	719	215	472
Toronto	1147	61	1208	219	6
Paris	481	202	683	156	87
Australia ⁽¹⁾	1445	40	1485	137	58
Zurich	166	213	379	130	N.A.
Italy ⁽¹⁾	204	0	204	120	32
Amsterdam	226	227	453	87	39
American	815	51	866	74	53
Hong Kong	264	12	276	54	45
Korea	389	0	389	33	25
Singapore	127	194	321	18	11

Source : FIBV International Statistics

(1) These figures include a number of exchanges.

APPENDIX 9

VIEWS OF INTERNATIONAL INVESTORS ON THE STOCK EXCHANGE OF HONG KONG

Summary of Burson-Marsteller's Study carried out for the SEHK

Introduction

Following the market crash in October, the Stock Exchange of Hong Kong (SEHK) commissioned Burson-Marsteller, a corporate, financial and marketing communications firm, to conduct a study on the then current attitudes of international investors towards Hong Kong as a financial and securities centre. It should be emphasised that the survey was taken soon after the October collapse when opinion in all markets was nervously uncertain and when, in addition to the market collapse, various management weaknesses in Hong Kong had become apparent.

Objectives and methodology

2. The objectives of the study were : -

- (a) to assess the overall perception of Hong Kong as an international and regional financial centre after the global equity crash in October 1987;
- (b) to measure the level of damage incurred internationally by Hong Kong's extreme share price fall, and its stock exchange closure;
- (c) to determine the level of knowledge of, and reactions to, specific actions taken by the Hong Kong Stock Exchange, Government, and media, following the crash; and
- (d) to determine the overall level of confidence in investing in Hong Kong and to solicit recommendations on improving that confidence.

3. A total of 31 members of the investment community in London, New York, Tokyo, Sydney and Hong Kong were interviewed during December 1987. Respondents included institutional portfolio fund managers, equity fund managers, department heads in retail brokerages and senior

institutional analysts. Due to the small sample size, the results are indicative rather than predictive. They, however, provide some illustrative comments on international investors' perception at that time of the Hong Kong stock market.

Main findings

4. Hong Kong was generally perceived as being a "second tier" capital market due to its small capitalisation and limited domestic market relative to major markets in London, New York and Tokyo, and thus "moderately important" on a global basis. It was often compared to the European markets in relative importance. Hong Kong's two greatest strengths were its regional role and its proximity to China.

5. However, it was seen as playing a leading role in the region compared to other markets with the majority of respondents, especially those from Hong Kong, Sydney and London (in that order), touting its strengths. Factors in Hong Kong's favour were the economy's growth prospects, the highly deregulated nature of the market, market liquidity and accessibility. It was also considered far easier to run a regional operation out of Hong Kong.

6. On the downside, some respondents, primarily from New York and Tokyo, characterized the market as relatively undeveloped, without the range of stocks of other leading markets and dominated by property.

7. Before the global equities crash, respondents averaged one per cent of their funds invested in the Hong Kong market though many had moved above this, out of line with the relative capitalisation of the market. It was felt that as a smaller market, Hong Kong was likely to be one of the first to be cut out of an investment portfolio during a global crash.

8. Most respondents agreed that the global stock market situation would dictate policies regarding buying Hong Kong equities. It was felt that Hong Kong would still be a key Asian market, though some noted that investors, who had been hurt by the closure, such as the Australians, would need to be convinced before investing in Hong Kong again. Hong Kong-based investment managers were the exception, with surprisingly bullish views on current values in Hong Kong.

9. Locally and internationally, both the stock market and the Stock Exchange were described as volatile and speculative. More than 50% of all respondents in Hong Kong, London, Tokyo and New York chose one of these two

words when characterising the institutions. Australian respondents were particularly negative in their characterisations of the Stock Exchange, calling it "dishonest", "corrupt", "unstable", "shady", "shambles", "unrepresentative", "opportunistic" and "a joke". Australia suffered a relatively larger crash than Hong Kong and Australian brokers blamed some of the severity of their crash on Sydney being open while Hong Kong was closed. In addition, an Australian journalist made world television headlines in an encounter with the then Chairman, Mr Ronald Li.

10. Hong Kong respondents pointed to lack of liquidity, leading to increased volatility, as the primary reason for the severity of Hong Kong's equity crash. International markets, especially London, cited the speculative nature of the market and the high proportion of foreign investment as the key contributing factors: - "Hong Kong had been a major beneficiary of global investment and as a result was severally hurt as overseas investors closed their positions to cover domestic losses".

11. Most respondents were well versed in the arguments for and against the closure and the majority were sharply against it, saying it had adversely affected the Exchange's international reputation and reduced confidence. Those most understanding of the closure were the US respondents who pointed out that several other markets were 'technically closed' and that there were special circumstances in Hong Kong. The least understanding were the Japanese.

12. However, respondents were unanimous in stating that the closure had damaged the Exchange's international reputation, certainly in the short-term. It was agreed that, if reforms were carried out in Hong Kong, when money can again be made in the market overseas investors will return. Japanese respondents were particularly harsh, saying the Stock Exchange of Hong Kong had severely damaged its most important asset - its image as a free market.

13. The appointments of Mr Robert Fell as Chief Executive of the Exchange, Mr Ian Hay Davison to head the Securities Review Committee, and Coopers & Lybrand (1) were known to varying degrees and almost universally welcomed. The exception was among Japanese respondents who had little or no knowledge of these developments. However, most

(1) Messrs Coopers & Lybrand, Accountants, were appointed by the SEHK Management Committee to review the surveillance arrangement at the SEHK.

respondents were unwilling to prejudge the issue and said they waited with interest to see what measures were introduced to reform the Exchange.

14. The Hong Kong Government was blamed for "not doing enough before the crash and too much after" by respondents in Hong Kong, London and Sydney. Interestingly, Japanese respondents heartily applauded the Government's bail-out efforts. Hong Kong respondents complained the Government did not know enough about how markets worked to act correctly.

15. The alleged conflict between international and local brokers was considered to have been blown out of proportion, "almost dangerously so", by analysts and fund managers in Hong Kong. However respondents in London and Sydney did not agree; they felt it was a serious issue and should be addressed, although few solutions were offered.

16. Media coverage of the Stock Exchange was rated sensational but fair. Respondents in London and Tokyo said they relied more on their brokers for information than on the media.

17. Respondents were almost unanimous in their opinion that confidence had been lost in the Exchange, and this was primarily due to the closure. A Hong Kong fund manager summed up many responses, "Actions speak louder than words. If what comes out of this is a better system that works efficiently and is seen by the international community to have high standards, then it will bring back confidence".

18. Respondents in both London and New York felt that the confidence issue was much broader and reflected a loss of investor confidence worldwide. Until the major markets recover there will not be a return of foreign capital to Hong Kong.

19. All respondents agreed that confidence would not and could not be restored overnight.

APPENDIX 10

DEVELOPMENT OF THE SECURITIES INDUSTRY IN HONG KONG

Background

Trading in equities has a long history in Hong Kong. The first stock exchange was established in 1891. This was the Association of Stockbrokers in Hong Kong which changed its name to the Hong Kong Stock Exchange in 1914. A second exchange, the Hong Kong Stockbrokers Association, was started in 1921 to give wider membership. These two exchanges were merged into the Hong Kong Stock Exchange in 1947.

2. For decades, the Hong Kong Stock Exchange played only a minor role in the Hong Kong capital markets, bank lending being the main source of finance for corporations. Up to 1962, there were only 65 companies listed on the exchange.

3. In the five year period from 1960 to 1965, the Hong Kong Stock Exchange experienced its first period of rapid expansion. Annual average turnover increased from \$200 million before 1960 to an average of \$852 million during the five year span. This increased activity was due partly to the general prosperity of Hong Kong and partly to the quality of shares that appeared in the market (1). The shares of these companies were priced at fixed levels which virtually ensured successful flotations. Many small investors made quick and easy profits during this period which helped shape the psychological attitude toward securities investment in the 1971-1973 boom. Development of the securities industry after the period was, however, hampered by the banking crisis in 1965 and the disturbances of 1967. Annual turnover for the period dropped to under \$350 million.

4. Despite the growth in the early part of the 1960's, the stock market remained peripheral to the Hong Kong capital market. In line with the non-interventionist policy of the Government, there was a virtually complete absence of regulation of the securities industry. This was not really surprising as the market was basically sound. There were few listed companies and most were

(1) Among the companies listed in the period 1961-1965 were the Hong Kong & China Gas Company Limited (1960), The Kowloon Motor Bus Co. (1933) Ltd. (1961) and the China Motor Bus Company, Ltd. (1962).

well-established enterprises with underlying assets which justified prices. There was, therefore, no urgent need for government supervision. Moreover, following the banking crisis during the latter part of the 1960's, the Government was engaged in the regulation of the banking industry.

5. The modern development of the securities industry in Hong Kong in terms of market development and statutory regulation took place in the last two decades.

6. The opening of the Far East Stock Exchange in December 1969 revolutionised the local stock market scene. The new exchange broke with the London-style business practices of the Hong Kong Stock Exchange and established rules suited to the Chinese business community. Trading was in Cantonese. Many local businessmen became stockbrokers with no qualifications other than an investment of \$500,000, the price of a seat on the Exchange. Listings were numerous and fairly easy to obtain. Stocks were priced at levels attractive to the ordinary investor and were traded in small board lots which made stock investment easy for the man in the street.

7. The Far East Stock Exchange very soon surpassed the Hong Kong Stock Exchange in terms of trading volume. Its success encouraged the establishment of further exchanges. The Kam Ngan Stock Exchange was opened in March 1971, its membership was connected with the long established Gold and Silver Trading Society, and the Kowloon Stock Exchange commenced trading in January 1972. By early 1973, the total number of broker members in Hong Kong exceeded 1,000. Plans were afoot to start a number of additional Exchanges.

8. Local companies, irrespective of their underlying assets or trading record, took advantage of the strong market and investor sentiment to go public. There was a proliferation of listed companies and more were waiting in the queue (2).

9. In an attempt to control the market, the Financial Secretary, announced in January 1973, the drafting of a new bill to regulate the securities industry. In the same month, a Securities Advisory Council was established and a Commissioner for Securities was appointed to pave the way for the enforcement of statutory provisions to be enacted. In response to news about the formation of a fifth

(2) During 1973 alone, there were 53 public offers and 48 placements of shares on the exchanges, bringing the total number of listed companies to 296 at the end of 1973.

exchange, emergency legislation - the Stock Exchange Control Ordinance - was enacted in February 1973 (3) to prohibit the creation of further exchanges.

10. Meanwhile, the bull market continued. Total turnover increased three-fold from \$14,806 million in 1971 to \$42,908 million in 1972 (4). The Hang Seng Index reached a record high of 1774.96 on 9 March 1973. There were relatively few institutional investors in the market and mutual funds were uncommon. Participants were mainly individual local investors, from middle class entrepreneurs to housewives and domestic maids. All were taking their life savings from banks and pouring them into the stock market.

11. The bull market was stopped dead in its track in March 1973. Prices fell as fast as they had risen. Within a matter of months, the Hang Seng Index fell from its all time high of 1775 points on 9 March 1973 to 437 points in December 1973 and reached a low of 150 points the following year. The crash was generally attributed to the psychological impact on small investors of such factors as concerns by analysts about the over-valuation of shares and the appearance of forged share certificates.

12. Prompted by the frenzied market activities the Securities Ordinance and the Protection of Investors Ordinance were enacted on 13 February 1974. Both were based on the recommendations of the Companies Law Revision Committee. They established, for the first time, a regulatory framework for the securities industry in Hong Kong. The Securities Ordinance also formally established the Securities Commission and the Commissioner for Securities.

13. The development of the regulatory framework (5) and increased prudential supervision of the securities

(3) The Stock Exchange Control Ordinance was repealed upon the enactment of the Securities Ordinance in February 1974.

(4) Similar growth was witnessed later during the periods 1977/78, 1979/80 and 1986/87 in each of which turnover was more than treble that of the preceding year.

(5) Regulatory activities in this period included the establishment of the Stock Exchanges Compensation Fund in August 1974, the Code on Takeovers and Mergers for Hong Kong approved by the Securities Commission in August 1975, the promulgation of the Securities (Stock Exchange Listing) Rules in 1976, the establishment of the Insider Trading Tribunal in 1977.

industry prompted the need for a joint body to represent the brokerage profession. The Hong Kong Federation of Stock Exchanges was formed in July 1974 and, up to its dissolution in April 1986, remained the consultative body representing the interests of the broking community.

14. In view of the difficulty of regulating four exchanges and the absence of unified rules and procedures essential to market expansion, unification of the four stock exchanges was first suggested in 1975 with the full support of the Securities Commission. Early in 1976, the Commissioner for Securities approached the exchanges with the idea; they refused to consider the matter.

15. In 1977, motivated by the continued decline of the stock market, the exchanges warmed to the idea of unification and a working party was set up under the chairmanship of the Commissioner for Securities. However, little progress was made in the two years that followed. When it became evident that unification on a voluntary basis was unattainable, the Government introduced legislation to bring it about. The Stock Exchanges Unification Ordinance, which provides for the establishment of a Unified Exchange, was enacted on 7 August 1980.

16. Under the Ordinance, the Stock Exchange of Hong Kong Limited, which was incorporated on 7 July 1980, was given an exclusive right to operate a stock market in Hong Kong, from a date to be appointed by the Financial Secretary. Invitations were then extended to all members of the four exchanges to apply for shares in the Company. The shares carried with them membership of the Unified Exchange. The move had a significant impact on the membership structure of the Unified Exchange.

17. The period leading towards unification also saw the introduction of international securities institutions in the Hong Kong market. Prior to 1979, overseas institutions were not allowed to trade directly on the Exchange. They could only trade through an existing full member. In 1979, the Far East Exchange, in an unprecedented move, admitted a representative of a Canadian stockbroker as a full member. Full membership soon followed for overseas members in the Hong Kong and Kam Ngan Stock Exchanges. Membership had, however, to be in the name of a sole trader. In practice, however, these institutions held seats on the Exchanges through the use of nominee members controlled by deeds of trust. This approach was carried over into the membership of the Unified Exchange. The Stock Exchanges Unification Ordinance disqualified banks, DTCs, corporations and firms from membership.

18. In 1982, to meet the changing needs of the securities industry, the Committee of the Unified Exchange proposed to remove the ban against corporations, local or international, so as to encourage participation by substantial wholesale dealers. This proposal led to amendments to the Stock Exchanges Unification Ordinance enacted in August 1985 which permitted corporations to become members of the Unified Exchange and removed the disqualifications for practising solicitors, accountants and directors or employees of banks and DTCs.

19. The period following the opening of the Unified Exchange on 2 April 1986 witnessed a vigorous bull market. The Hong Kong stock market also began to assume the characteristics of an international exchange.

20. Following the global bull market and supported by strong local economic performance, the stock market surged. The Hang Seng Index reached an all time high of 3949.73 on 1 October 1987 and the highest daily turnover record was set the following day at a figure of \$5,407.55 million (US\$693.28 million). In effect, share prices increased by 89% in the 12-month period between 1 October 1986 and 1 October 1987, while turnover almost trebled over the same period. The advance was fuelled by substantial corporate activity, including encouraging company results, new issues, takeovers and capital restructurings. From end-April 1986 to end-September 1987, the number of listed companies increased from 251 to 272. There were 20 reconstructions of companies or re-activations of shell companies during the same period.

21. The period also saw a significant increase in overseas investment in the local market. Although many of the international brokers are indirectly affiliated with American parents the preponderance have their immediate head offices in London. Although no statistics are available on the amount of trading attributed to international investors, the contribution of corporate members is a reasonable reflection of their involvement. It is widely accepted that corporate members, many of whom are part of the international brokerage community, account for a very high proportion of the international business conducted on the Exchange. The number of corporate members on the Unified Exchange grew from eight in April 1986 to 85 at the end of December 1987. Their contribution to the trading volume, in value terms, rose from 23.17% in April 1986 to an average of 50% throughout 1987 and touched a peak of 57% in April 1987.

22. Market sentiments remained bullish immediately prior to the market collapse. Securities analysts were convinced that the bull market, supported by strong fundamentals, would run further (6). In the week preceding 19 October 1987, the Hang Seng Index fell only 99 points or 2.6% in response to an almost 10.5% drop in Dow Jones Industrial Index over three days' trading.

23. On Monday, 19 October 1987, the worldwide "free fall" began. In Hong Kong, the Hang Seng Index fell 420.81 points to 3,362.39, a drop of 11.1 %. The market closed and the events leading to this report, described in Chapter I, began.

-
- (6) In its October Hong Kong newsletter, Jardine Fleming (Securities) Limited stated that "notwithstanding the recent sharp runup in share prices, the pillars on which this bull market is founded are intact the market is still trading at an attractive level given the growth rate of corporate profits and the rating of other markets worldwide."

APPENDIX 11

THE STOCK EXCHANGE OF HONG KONG MARKET CAPITALIZATION BY SECTORS AT END 1987

	<u>%</u>
Finance	16.30
Utilities	17.47
Properties	26.11
Consolidated Enterprises	29.61
Industrials	6.38
Hotels	4.08
Others	0.05
Total	<u>100.00</u> =====

Source : The Stock Exchange of Hong Kong Limited
Fact Book 1987

APPENDIX 12

THE STOCK EXCHANGE OF HONG KONG LIMITED INCOME FOR THE YEAR ENDING 30 JUNE 1987

<u>Source</u>	<u>Income</u> (HK \$'000)
Transaction Levy	122,348
Listing Fees	24,442
Audio Broadcast and Sales of Teletext Terminals	8,874
Application Fees and Members Subscription	6,078
Interest Income	2,176
Advertising and Sales of Publications	1,634
Ancillary Income	360
	<hr/>
	\$165,912
	=====

Source: The Stock Exchange of Hong Kong Limited
Annual Report 1987

APPENDIX 13

THE STOCK EXCHANGE OF HONG KONG NUMBERS OF INDIVIDUAL AND CORPORATE MEMBERS

(April 1986 to April 1988)

<u>Date</u> <u>(end of month)</u>	<u>Individual</u> <u>Members</u>	<u>Corporate</u> <u>Members</u>	<u>Total</u>
2nd April 1986*	892	8	900
June 1986	860	22	882
September 1986	832	34	866
December 1986	788	51	839
March 1987	760	58	818
June 1987	736	68	804
September 1987	714	75	789
December 1987	688	85	773
March 1988	669	96	765
April 1988	664	98	762

* Unified Exchange commenced trading

Source : The Stock Exchange of Hong Kong Limited

APPENDIX 14

RELATIVE CONTRIBUTION OF INDIVIDUAL AND CORPORATE MEMBERS TO STOCK MARKET TURNOVER BY VALUE

(April 1986 to April 1988)

<u>Month</u>	<u>Total Turnover</u> (\$ million)	<u>Contribution by</u> <u>Individual Members</u> (\$ million)	<u>Contribution by</u> <u>Corporate Members</u> (\$ million)
1986			
Apr	9,350.33	7,183.86 (76.83)	2,166.47 (23.17)
May	8,033.33	5,699.65 (70.95)	2,333.68 (29.05)
Jun	4,978.36	3,059.20 (61.45)	1,919.16 (38.55)
Jul	8,486.57	4,913.72 (57.90)	3,572.85 (42.10)
Aug	9,836.58	5,648.16 (57.42)	4,188.42 (42.58)
Sep	11,432.84	6,937.45 (60.68)	4,495.39 (39.32)
Oct	23,125.18	10,732.40 (46.41)	12,392.78 (53.59)
Nov	14,577.09	7,392.04 (50.71)	7,185.05 (49.29)
Dec	19,188.88	9,644.33 (50.26)	9,544.55 (49.74)
1987			
Jan	21,691.02	11,372.60 (52.43)	10,318.42 (47.57)
Feb	28,260.26	14,568.16 (51.55)	13,692.10 (48.45)
Mar	23,772.52	11,912.41 (50.11)	11,860.11 (49.89)
Apr	14,004.69	5,711.11 (40.78)	8,293.58 (59.22)
May	21,617.59	9,286.92 (42.96)	12,330.67 (57.04)
Jun	25,993.05	11,938.61 (45.93)	14,054.44 (54.07)
Jul	34,978.71	16,733.81 (47.84)	18,244.90 (52.16)

<u>Month</u>	<u>Total Turnover</u> (\$ million)	<u>Contribution by</u> <u>Individual Members</u> (\$ million)	<u>Contribution by</u> <u>Corporate Members</u> (\$ million)
Aug	40,557.29	18,291.34 (45.10)	22,265.95 (54.90)
Sep	60,372.23	29,057.15 (48.13)	31,315.08 (51.87)
Oct	61,887.50	28,957.16 (46.79)	32,930.34 (53.21)
Nov	22,320.90	10,638.14 (47.66)	11,682.76 (52.34)
Dec	15,950.70	7,898.79 (49.52)	8,051.91 (50.48)
1988			
Jan	16,217.14	7,615.57 (46.96)	8,601.57 (53.04)
Feb	9,302.63	3,662.45 (39.37)	5,640.18 (60.63)
Mar	23,940.19	10,239.22 (42.77)	13,700.97 (57.23)
Apr	18,758.08	8,026.58 (42.79)	10,731.50 (57.21)
	-----	-----	-----
	548,633.66 =====	267,120.83 (48.69) =====	281,512.83 (51.31) =====

Figures in () equal % of total market turnover

Source : The Stock Exchange of Hong Kong Limited

APPENDIX 15

SUB-COMMITTEES OF THE STOCK EXCHANGE OF HONG KONG

- (1) Executive
- (2) Membership
- (3) Disciplinary
- (4) Financial Investigation
- (5) Listing
- (6) Floor Trading
- (7) Technical Services
- (8) Central Clearing
- (9) Rules
- (10) Finance
- (11) Training
- (12) Public Relations
- (13) Publications
- (14) Fidelity Fund

Source : Rules of the Exchange
The Stock Exchange of Hong Kong Limited

APPENDIX 16

RULE 226 OF THE STOCK EXCHANGE PROVIDING FOR SPECIFIC POWERS OF THE CHIEF EXECUTIVE

Without prejudice to Rule 225 above and any other provisions in these Rules expressly conferring power upon the Chief Executive, the Chief Executive shall have such powers as the Committee or any Sub-Committee may confer upon him including, in particular, the following powers :

- (1) to supervise the trading activities at the trading hall of the Exchange and to take all necessary steps to maintain orderly and efficient trading, in accordance with the Rules of the Exchange; and to suspend trading in any issue of securities or by any Member in the manner as provided in these Rules or as directed or authorized by the Committee or any Sub-Committee;
- (2) to be responsible for the employment of staff and officers of the Exchange;
- (3) to report periodically to the Committee on all matters concerning the Exchange or on such occasions as may be expedient;
- (4) to scrutinize and manage all matters relating to listing, membership including applications for membership;
- (5) to exercise such disciplinary measures over the Members or their Authorized Clerks, Sales Representatives and Dealing Directors in any manner as herein after provided in these Rules in order to ensure compliance with the Securities Ordinance, the Unification Ordinance, the Articles and these Rules;
- (6) to approve the appointment of any Authorized Clerk, Sales Representative or Dealing Director or to expunge the name of any Authorized Clerk, Sales Representative or Dealing Director from the Register of Authorized Clerks, Sales Representatives or Dealing Directors;

- (7) to ensure good order and behaviour in the trading hall of the Exchange and for this purpose, to refuse entry to any person and to remove any person from the trading hall;
- (8) to attend all meetings of the Sub-Committees; and
- (9) to release at his absolute discretion information as to any Member's financial position or otherwise to the Commission or the Commissioner when so requested by any of them.

Source : Rules of the Exchange
The Stock Exchange of Hong Kong Limited

APPENDIX 17

SUMMARY OF THE MANAGEMENT PROPOSALS OF THE STOCK EXCHANGE OF HONG KONG 1988

The Exchange's management proposals cover the following five main areas.

Organisational improvements

2. The management structure will broadly be divided into seven Divisions, i.e. Listing, Operational, Secretariat, Finance, Compliance, Management and Research and Publication overseeing 18 Departments. While the Council will continue to be responsible for policy, the day-to-day operations will be in the hands of the executive staff who will work to a network of sub-committees with clearly delegated authority. The sub-committees will be responsible for reporting to the Council.

3. The staff will work to a Chief Executive who will be responsible for formulating policy proposals for consideration by the Council. Within the policies and budget approved by the Council, he will have the authority to take the necessary action to ensure efficient management and administration of the Exchange. He will be the principal representative of the Exchange both locally and internationally.

4. The Chief Executive will be supported by a Deputy Chief Executive. There will be a tier of senior executives at Divisional level supported by managers at the Departmental level. The Division Heads will supervise the Department Heads to ensure that all operations are carried out efficiently. They will also act as a buffer between operations and decision making to ensure that action appropriate to the Exchange's strategy is carried out.

Reforms on listing

5. Following a review of the Exchange's listing rules and procedures by experts from the International Stock Exchange in London, changes have already been introduced in the procedures⁽¹⁾. New accommodation has been acquired for the Listing Division and staff recruitment is under way.

(1) See Appendix 18.

6. In addition to an Office Manager responsible for Personnel, Property and Accounts who will work directly to the division head, the Division will have the following three operational Departments :-

- (a) New Issues;
- (b) Listed Securities Administration; and
- (c) Information.

7. The Head of Listings will be responsible for both external liaison (Registrar General, Society of Accountants, Commissioner for Securities etc); and internal liaison (Chief Executive's Management Committee, Listing Committee etc). His functions will include recruitment, training and management, maintaining and developing listing standards, general policy matters, reviewing market practices etc.

(a) New Issues Department

8. The New Issues Department, will have the following duties :-

- (a) listing policy and rules;
- (b) applications for listing;
- (c) new issue document reading; and
- (d) serving and liaison with the Listing Committee.

9. The Department will be small, about 11 in number including three examining officers supported by two document readers and legal accountancy advisers (who will also be available to advise the other Departments).

(b) Listed Securities Administration Department

10. This Department, which is likely to be the largest, is essentially the market surveillance area. It will : -

- (a) monitor compliance with the Listing Agreement
- . company announcements

- . company results
 - . capital expansions and re-organisations
 - . take-overs and mergers
- (b) monitor special situations
- . peculiar price movements
 - . unauthorised statements or press and analysts' comments
 - . market rumours
- (c) order trading suspensions.

11. It will also liaise with the firm surveillance area and the Information Department regarding company announcements and sponsoring brokers.

12. The Chief Executive envisages nine monitoring groups, each consisting of an examining officer and a document reader. Each group would be responsible for a number of related securities, - e.g. Hang Seng Index components, financials, utilities, properties, conglomerates etc.

(c) Information Department

13. This will be responsible for the timely flow of information to the market and the investing public. Duties will cover : -

- (a) receipt and dissemination of company information;
- (b) provision of information to Listing Division; and
- (c) liaison with surveillance area on market monitoring.

14. The immediate tasks facing the Listing Division are recruitment, assembling a data base and putting together systems. The duties of the Listing Committee are to be fixed.

Strengthening of the surveillance capabilities

15. The Surveillance Department is under the management of a London-trained chartered accountant who joined the Exchange in August 1987. A leading accounting firm was engaged to advise on the future staffing of the Department and on the necessary procedures for the better surveillance of members firms. In addition, the firm has seconded staff under a partner to work in the area of members' surveillance. They are assisted in legal matters by the Exchange's legal advisers. A senior accountant will shortly join the Exchange to become the Head of the Compliance Division of which the Surveillance Department will form a part.

Tightening up financial control

16. The accounting firm also undertook a review of the finances of the Exchange. Steps have been taken to implement a proper system of budgetary control and a new computerised financial accounting system. These should be operational before the second half of 1988. Pending the recruitment of permanent accounting staff to run the Finance Division, staff from the accounting firm have been seconded to the Exchange to control the day-to-day accounting functions. The permanent head of the department, an experienced chartered accountant, has now been recruited.

17. In addition, the considerable reserves of the Exchange have been put under proper management. In February 1988, \$100 million of the Exchange's reserves have been contracted out to a fund manager for a period of 12 months. The remainder is retained in the form of short-term deposits pending finalisation of the cash flow projections of the Exchange.

Strengthening of the staff and operations

18. Another consulting firm was engaged to review and advise on executive remuneration and to assist in the general recruitment of staff.

19. Recruitment for staff of the Operations Division, covering trading, settlement and the general provision of technical services to the Exchange, is under way. Particular attention is being paid to the provision of technical services for effective market surveillance and for the flow of information to the market from the Listing Department. Resources are also being dedicated to develop short- and long-term settlement systems and to computerise listings, membership and accounts returns.

APPENDIX 18

REPORT ON THE LISTING RULES AND PROCEDURES OF THE STOCK EXCHANGE OF HONG KONG : SUMMARY OF RECOMMENDATIONS

The International Stock Exchange (ISE) in London was appointed to review the Listing Rules and procedures of the Listing Department of the Stock Exchange of Hong Kong in early 1988. Its report identified three major areas for improvement.

The Exchange Listing Rules

2. The ISE recommended two categories of amendments to the Listing Rules, namely : -

Category (1) parts of the Rules needing general enhancement to reflect current best practice; and

Category (2) specific matters to be addressed by revising individual listing rules.

3. Regarding Category (1), the ISE recommended that : -

- (a) the content of prospectuses and circulars to shareholders should be enhanced. Consideration should be given to incorporating requirements for reports from the sponsor and reporting accountants on profit forecasts, and the inclusion of statements regarding material changes, if any, in the issuer's financial position since the date of its latest annual accounts;
- (b) the requirement to include an accountants' report and the information to be disclosed therein should be expanded so that accountants' reports reflect best practice under the generally accepted accounting principles in Hong Kong; and

- (c) the content of the listing agreement should be expanded to reflect best practice for conduct of and disclosure of information by listed companies, as well as providing for reduced requirements for issuers with only debt securities listed.

4. Regarding Category (2), the ISE recommended a number of amendments to the Listing Rules on (a) trading record; (b) major disposals and shell companies; (c) acquisitions and disposals; (d) placings and introductions; (e) offers for subscription or sale - the queue system; (f) warrants to subscribe and; (g) role of the sponsor.

Company information

5. The ISE believe that to maintain public confidence in the marketplace, board deliberations should be made in strict confidence. Third parties should be informed only when a decision has been reached. Once communication is to be made, the news must be made available as quickly as possible to the widest spectrum of the public. This will entail establishment of a central focus for collation and dissemination of news to the market to enable the price of a security to reflect the latest information thus putting both parties to a transaction in the securities in possession of the same knowledge.

Organization of the Listing Department

6. The ISE pointed out the importance of striking a balance in apportioning the work and responsibilities of the Committee and the executive of the Exchange. To achieve this, there should be more delegation from the Committee to the executive.

7. Regarding the internal structure and composition of the Listing Department, the ISE recommended that there should be more staff working in less cramped office accommodation to enhance the quality of regulation of listed companies.

APPENDIX 19

THE STOCK EXCHANGE OF HONG KONG

SUSPENSION OF LISTINGS

(April 1986 - March 1988)

<u>Quarter</u>	<u>Total</u>	<u>Suspensions at the company's request</u>				<u>Suspension at the authorities' request</u>
		<u>one day or less</u>	<u>one week or less</u>	<u>longer</u>	<u>(still) (suspended)</u>	
II 1986	17	8	5	4	-	-
III 1986	18	4	10	4	1	-
IV 1986	35	13	8	14	2	-
I 1987	32	9	17	6	1	-
II 1987	23	7	15	1	-	3
III 1987	48	15	28	5	1	-
IV 1987	39	10	13	16	2	1
I 1988	19	5	10	4	1	1
	<u>231</u>	<u>71</u>	<u>106</u>	<u>54</u>	<u>8⁽¹⁾</u>	<u>5</u>

(1) Included in the preceding column of figures of company requested suspensions longer than one week.

Source : The Stock Exchange of Hong Kong Limited.

APPENDIX 20

INTERIM MEASURES TO MITIGATE SETTLEMENT AND REGISTRATION PROBLEMS SUGGESTED IN THE SUBMISSIONS TO THE SECURITIES REVIEW COMMITTEE

- (a) To open a central clearing room where brokers could meet daily for collective clearing.
- (b) To lengthen the settlement period.
- (c) To move to a system where trades are value-dated i.e. for delivery on a mutually agreed specified day.
- (d) To put the transfer form onto the back of share certificates, so as to reduce the amount of paper.
- (e) To standardise the board lot size which at present varies between 100 and 5,000 shares depending on the company.
- (f) To increase the board lot size of companies with low share trading price so as to reduce the amount of share certificates to be transferred.
- (g) To standardise transfer forms which are currently company-specific.
- (h) To introduce a system of certified transfers which involves the registrar issuing (pending registration) a piece of paper which states that, on a first check, they are satisfied the holder is a proper transferee; certified transfer forms would be negotiable and could be split to facilitate partial re-sale.
- (i) As a variant of (i), to introduce depository receipts (along the lines of the American Deposit Receipt which allows non-US shares to be freely traded in the US) which would be issued by a bank custodian and give title to shares held by the bank. The depository receipt could be freely traded as a bearer instrument.
- (j) To change the stamp duty rules in order to make stock lending cheap and easy.
- (k) To reduce the period required for the registration of shares.
- (l) To introduce a system of record dates for rights issues etc rather than close the books for a period.

APPENDIX 21

STOCK INDEX FUTURES

Introduction

This appendix summarises the construction and functions of stock index futures and the trading strategies used in derivative product markets (1).

2. Stock index futures were first introduced by the US Kansas City Board of Trade on 4 February 1982. The Chicago Mercantile Exchange opened trading in the S&P 500, by far the most active contract in the world, just two months later. Since then, stock index futures contracts have mushroomed, with over half a dozen in the US; one in the UK; one in Australia; one in Japan (with another on the way); one in Singapore; and one in Toronto. And of course the Hong Kong Futures Exchange (HKFE) introduced the Hang Seng Index contract in May 1986.

3. Because a futures contract is a single instrument which mirrors, and can therefore be used as a surrogate for, a basket of stocks, it opens up a whole range of possible trading strategies.

Hedging

4. An investor in a portfolio of stocks which is identical to or closely tracks the index is able to hedge his exposure to price movements by selling index futures. Provided the futures market accurately tracks the cash market, any losses in the cash market (2) should be offset by corresponding gains in the futures market. The opposite also applies, however. Any gains in the cash market will be foregone through equivalent losses in the futures market; in consequence, if the hedge were always maintained, the attractions of investing in stocks would be significantly reduced.

(1) A "derivative product" is an instrument which is based on another instrument or product. Futures and options are both examples of derivative products.

(2) "Cash market" is an expression used to refer to the market in the underlying instruments - in this case, the stock market where the constituents of the index are traded.

5. Hedging might therefore occur when an investor with an open cash market position wishes to lock in his profit because he has become nervous about market conditions. His confidence might later recover, causing him to unwind his futures position (possibly at a cash loss) in order to re-open his cash market position. Alternatively, he might use the futures market actively, locking in his profits at successively higher levels, although that increases transaction costs of course. A hedge position might also be taken if the investor is looking for income rather than capital gain.

6. In addition, an investor in a single stock is able to reduce his exposure to general market movements by selling index futures. His residual exposure is to movements in the price of the particular stock against the market (a risk measured by the stock's beta factor). This strategy might be used by merchant banks and institutional underwriters to a new issue.

7. The hedger cannot guarantee to eliminate risk, however, as the hedge will be imperfect whenever his portfolio behaves differently from the index; or the relationship between the futures contract and the underlying index behaves in an abnormal or unexpected way.

Speculation

8. A speculator is someone who is prepared to punt on the market rising or falling by taking on an open position. Because transaction costs are considerably lower in the futures market than in the cash market, stock index trading is particularly attractive to speculators. First, the bar to entry is lower. Secondly, the gearing is better: for simplicity, assume a futures market margin requirement of 10% and a cash market margin requirement of 50%; in the futures market, a speculator with a long position can double his money if prices rise 10%; in the cash market, prices must rise by five times as much for the same return to be secured.

9. It is helpful, for analytical purposes, to put speculators into two groups - those who will take overnight or even longer exposures; and those who take intra-day open positions. So-called "locals" typically only take intra-day positions, jobbing in and out of the market to exploit short-term price fluctuations. As such they provide useful liquidity to the market and might even be regarded as quasi market-makers. But, as the events of October 1987 demonstrated, they may not stay around in violent markets - it is simply too dangerous; they are certainly not under any obligation to make markets.

Index arbitrage

10. The difference between the value of the index and the futures contract is called the "basis". This should not be too great as the value of a futures contract should obviously track the value of the underlying index, with the two converging at the delivery date. There are a number of factors making for slight differences, however :-

- (a) the future is worth more to the extent that the investor saves the financing costs of holding the underlying portfolio; but
- (b) it is worth less to the extent that the futures investor foregoes the dividend income received by an investor in the underlying stocks.

11. The theoretical value of the future is therefore determined by the prevailing interest rate, the prevailing dividend rate, the time left to expiry, and relative transaction costs; in combination, this is referred to as the "cost of carry". In most markets, the future's theoretical value has typically been slightly greater than the underlying index in recent years.

12. In practice of course, the future does not stick to its theoretical course. Stock index arbitrage is designed to exploit such divergences. This is possible because, whatever the divergences during a contract period and whatever the volume of arbitrage activity, the prices will converge at the expiry date as the delivery (or settlement) price is determined by the cash price.

13. Thus, if the future is at a sufficient premium to the cash, the arbitrageur buys in the cash market (3) and sells futures. Or, if the future is at a discount to its theoretical value - perhaps in dull or bearish markets - the arbitrageur buys the future and sells in the cash market (i.e. he takes a short position in the stock market).

-
- (3) In practice, given the costs of assembling the whole of the index in the cash market, an arbitrageur will usually attempt to replicate the index with a smaller basket of securities which closely tracks the index.

14. One of the important features of arbitrage therefore is that, in efficient markets, it should bring prices back into line - i.e. when the premium is too high arbitrageurs selling the future and buying the cash in sufficient volumes should depress futures prices and underpin cash market prices. Theoretically, if it goes too far, reverse arbitrage opportunities arise, and so on until equilibrium is reached.

15. It should be noted that, as the arbitrageur is locking in to a hedged position at a fixed rate of return, arbitrage can be an attractive strategy, particularly if the abnormally large premium (or discount) occurs near the beginning of a contract period. For example, if the premium on day 10 of a 30-day contract is 1%, this is equivalent to 0.05% per day remaining before expiry, providing an annualised return of slightly over 18%, before transaction costs and the cost of funding the long cash market position. Arbitrage is therefore attractive to fund and money managers looking for a high yield investment; indeed the transactions can be viewed as a synthetic money market operation.

16. Opportunities to roll-over an arbitrage position into a more distant contract period can arise when the premium (or discount) is fairly constant; the existing future is bought back (or sold), with the new contract being sold (or bought). This is particularly attractive for a long arbitrageur (4) as the same stock position can be used. It is slightly more tricky for a short arbitrageur as he must re-establish his short position (or extend his stock borrowing commitment).

17. An arbitrageur's expected profit may not be realised, however, if the constructed basket of stocks ceases to track the market, or if the execution of trades has a material impact on the market. The most extreme case would be where, in unwinding a long cash market position, the sale of stocks depressed the market to the extent that some of the basket was sold at lower than expected prices. Furthermore, problems could be experienced in unwinding a large long arbitrage position in a bear market as the arbitrageur may not be able to find buyers.

(4) A "long arbitrageur" has a long position in the stock market and a short position in the futures market.

18. Finally, it should be noted that an arbitrageur does not have a direct interest in holding the underlying stock portfolio - he is not an investor. At the expiry date (or before if relative prices move back into line), the arbitrageur settles or reverses his transaction in both markets. This can lead to significant stock selling/buying, which was one of the factors lying behind the "triple witching hour" phenomenon in the US. The arbitrageur's "lack of interest" in the spot market is also one of the elements which, it is said, can contribute to a "cascade scenario" (see below).

Index substitution

19. The development of institutional investment and pooled investment schemes over the past decade or so is based, inter alia, on the premise that an investor should in the long run improve his return by holding a diversified basket of stocks and shares. In recent years, there has been growing criticism of fund managers' failure to out-perform the index. Faced with the difficulty of beating the market, they have tended to simply buy the whole market. This has prompted the growth of so-called index funds, which are carefully constructed to replicate (or at least nearly match) the index in terms of constituent stocks, relative weightings etc.

20. Two consequences are first that investors become relatively more interested in events which impact on the market as a whole as opposed to developments concerning individual securities. And secondly, that the investor can just as easily buy the index via the futures market; and indeed, it will usually be cheaper to do so.

21. As well as taking naked long positions in the futures market to replicate the index, an index fund might also engage in a form of arbitrage. If the future trades at a discount to its theoretical level, the fund may buy futures and sell stocks, investing the proceeds in money market instruments and thus enhancing the yield achieved by the fund relative to the market. The stock sales may be actual, so that this activity can occur in markets which bar short sales - such as Hong Kong; and can continue when prices are falling in markets where short selling is only permitted on an uptick- such as the US.

Portfolio insurance

22. Most portfolios are not 100% equities but rather a mixture of equities, bonds and cash, with the balance being varied from time to time according to expectations of prospective market performance and changing risk/return equations. Thus, if an investor begins to feel jittery about the market, he will typically reduce the equity element and increase bond/cash element (in this context bonds may be regarded as cash).

23. Traditionally this has involved the actual sale and later re-purchase of equities etc. Portfolio insurance is a trading strategy which involves using futures to adjust the de facto level of securities and cash in the portfolio without actually having to trade in the securities market. Given transaction costs in the futures market are generally lower, it should save money and give fund managers greater flexibility.

24. For example, if an investor develops bearish sentiments, he will sell futures creating a hedged synthetic cash position for part of the portfolio, thereby reducing the de facto equity element of the portfolio. Conversely, if the investor is bullish, he buys futures to increase the de facto equity weighting of the portfolio.

25. In some instances portfolio insurance has apparently been used to "guarantee" a certain level of return, with the strategy being used semi-automatically; a specified fall/rise in stock prices triggers the sale/purchase of a specified amount of futures.

26. Because adjustments are made on a continual basis, portfolio insurance is sometimes referred to as "dynamic hedging".

Programme trading

27. Programme trading is a generic term used to describe the practice of using computer programmes to indicate when and how to implement one or any of the trading strategies described above. It does not involve the automatic, computer driven execution of such strategies. Examples would involve a computer calculating when arbitrage would be profitable taking all the costs into account; or triggering portfolio insurance futures selling when the stock index fell by a specified amount.

APPENDIX 22

HISTORY AND DEVELOPMENT OF THE HONG KONG FUTURES MARKET

Background

From 1910 to 1977 the only commodities trading in Hong Kong was at the Chinese Gold and Silver Exchange Society, which was and is completely self-regulated. This was because of lack of interest rather than regulation as up to 1973 there were no legal constraints on commodity or futures trading.

2. However, on 20 June 1973, when several groups expressed an interest in setting up commodity exchanges, the Government announced a temporary ban which was followed in August by the introduction of legislation, the Commodity Exchanges (Prohibition) Ordinance (Cap. 82), preventing the establishment and operation of new commodity exchanges until such time as their desirability had been determined and further legislation had been enacted for their proper regulation. The Ordinance did not apply to the Gold and Silver Exchange.

3. Having applied this brake, the Government established a Steering Group to assess the feasibility studies being prepared by the various interested parties. In 1974, the Group concluded, inter alia, that -

- (a) the establishment of a properly regulated and controlled commodity exchange would, on balance, bring financial and economic benefits to Hong Kong;
- (b) a commodity futures exchange was by nature a market of professional traders and its rules should discourage the participation of the ordinary public;
- (c) its main function would be to provide hedging facilities against fluctuations in prices of raw or semi-processed materials; and
- (d) it could not succeed if it had purely local participation.

Establishment of the Hong Kong Commodities Exchange

4. In 1975, the Legislative Council approved in principle the proposal to establish a commodity exchange in Hong Kong provided that social hazards to the ordinary citizens of Hong Kong could be minimized. The Commodities Trading Ordinance was subsequently enacted to enable the opening of an exchange in Hong Kong and to regulate futures trading. In 1977, a licence was issued by the Governor-in-Council to the Hong Kong Commodities Exchange Limited (HKCE), subject to a review after five years.

5. The HKCE opened markets in cotton and sugar in 1977, soybeans in 1979, and gold in 1980. The cotton market did not succeed and ceased trading in 1981. Trading in the remaining markets was thin.

6. As required under the terms of the licence, the Government established a Working Party in 1982 to review the Exchange and the Commodities Trading Ordinance. The Working Party completed its review in November 1983, concluding that the HKCE had not been a success. There were quite severe management problems and it had not brought any significant advantage to local commodities users.

Seacom Holdings

7. The genesis of these management problems lay in Seacom Holdings which was owned by a group of Hong Kong business interests had been authorised by the Government in 1974 to promote the formation of a commodity exchange. In effect the Exchange was to a large degree controlled by Seacom which had the right to appoint the President of the management committee and the Secretary of the Exchange and to nominate half the board of directors.

8. International Commodities Clearing House (ICCH) negotiated its appointment as clearing house with this group who sought to establish an arrangement whereby they would be joint owners of the clearing house and thus share the profit with ICCH. ICCH however rejected this idea on the grounds that it would not be able to carry out its function in an independent manner if the promoters, who were also potential members of the Exchange, were able to influence decisions at Board level.

9. As an alternative to taking equity in the clearing house Seacom was offered equity in the Guarantee Corporation. This alternative was rejected by them when they realised the potential risk that they would be taking

on. Agreement was, however, reached just prior to commencement of trading on the new Exchange whereby Seacom were to be paid a commission on each registration fee collected by ICCH. The amount of commission to be paid was based on a sliding scale according to turnover.

Re-organisation of the Hong Kong Futures Exchange

10. On the basis of the Working Party's recommendations, the Government decided in 1984 to renew the licence of the Exchange provided that -

- (a) the Exchange was re-organized to widen its membership and strengthen its executive and Board;
- (b) efforts were made to develop new contracts with larger local appeal and international characteristics to improve its viability; and
- (c) the Commodities Trading Ordinance was appropriately amended to strengthen the prudential supervision of the Exchange.

11. The Government also decided that a further licence review should be conducted three years later to check whether these conditions had been met.

12. At around this time, a new chairman, Dr. Kim Cham, was appointed and a series of management improvements were introduced.

Hang Seng Index Futures Contract

13. In the course of the licence review, a consortium of banks put forward a comprehensive proposal to establish a financial futures market in Hong Kong. To avoid having two separate exchanges, the Government encouraged the consortium to work with the HKCE to develop joint proposals for a financial futures market in Hong Kong. This culminated in an HKCE proposal to change its name from "Commodities" Exchange to "Futures" Exchange and to broaden its membership to include, inter alia, subsidiaries of banks. It further proposed that a stock index future should be the first contract.

14. The proposed contract was approved by the Government in 1984 when the licence of the Exchange was renewed.

The Vercelli Agreement

15. The Government's new proposals meant that Seacom no longer enjoyed special status as the original promoter of the Exchange. The parties who owned the defunct Seacom were allowed to retain an interest in the profits earned by ICCH but not directly as before from a commission arising from registration fees. Instead they formed a new company called Vercelli Company Limited which entered into a consultancy contract with ICCH(HK) to promote the HKFE. In return for carrying out these consultancy duties Vercelli was to be paid an annual fee proportional to the current and expected profits of ICCH(HK). The consultancy contract was terminated in October 1987.

Trading Volumes

16. Trading in the Hang Seng Index futures contracts commenced in May 1986 and quickly exceeded the other contracts in volume, accounting for 80% of the total market turnover of the Exchange in 1987 (1). However, boom had led to bust by October 1987.

(1) Monthly trading volumes and relative market share of the various contracts on the HKFE from January 1986 to April 1988 are contained in Tables 1 and 2 below.

TABLE 1

Monthly trading volumes (in lots)
of various contracts on the HKFE
January 1986 to April 1988

	<u>Hang Seng Index</u>	<u>Soybeans</u>	<u>Sugar</u>	<u>Gold</u>
1986 (monthly average)	103160	27544	22817	531
1987				
Jan	185380	26311	33030	488
Feb	222859	51468	27608	522
Mar	323361	26332	38850	574
Apr	276529	38228	23420	520
May	293001	63969	22894	546
Jun	340994	48885	18097	520
Jul	420505	49419	20247	600
Aug	483389	47683	14910	518
Sep	601005	67619	22193	574
Oct	399606	85279	22764	492
Nov	47194	71674	17371	168
Dec	17486	59108	20853	176
1988				
Jan	15471	34160	20226	160
Feb	12130	25163	18552	144
Mar	14388	36899	15372	184
Apr	16247	29047	11559	144

Source: Hong Kong Futures Exchange Ltd.

Table 2

Relative market share of the
various contracts on the HKFE
1986 to 1988 (January to April)

	<u>Value (\$ million) of turnover for the year</u>		
	<u>1986</u>	<u>1987</u>	<u>1988</u> (Jan to Apr)
Hang Seng Index	89784 (81.6)	585078 (93.4)	7208 (41.7)
Soybeans	17756 (16.1)	38936 (6.2)	9389 (54.3)
Sugar	2225 (2.0)	2448 (0.4)	679 (4.0)
Gold	242 (0.2)	260 (0.0)	30 (0.2)

Figures in brackets refer to the percentage of total turnover. Where they do not add up to 100%, this is because of rounding up.

Source : Hong Kong Futures Exchange Ltd.

APPENDIX 23

THE HANG SENG INDEX MARKET

In this Appendix we briefly summarise the development of the Hang Seng Index (HSI) futures market from its launch in May 1986 to its nadir in October 1987. Our assessment of the contract and the market is contained in Chapter VI.

The Hang Seng Index

2. The index futures contracts traded on the HKFE are based on the Hang Seng Index, which is compiled and managed by HSI Services Ltd., a wholly owned subsidiary of Hang Seng Bank Ltd. The index was launched in November 1969, using 31 July 1963 as the base date (using 100 as the base figure) and is the most widely quoted indicator of general price movements on the Hong Kong stock market. It is computed and released once a minute through the Teletext system of the Stock Exchange and Reuters Monitor Equities Investment Service. A Hang Seng Index Daily Bulletin recording the level of the index at 15 minutes intervals and high/low/close for each day, is also published.

3. The index comprises 33 stocks and is capitalisation weighted; the respective weightings of the individual components is shown in Annex 1.

4. Although the number of companies listed on the Hong Kong stock market has increased from 73 in 1969 to over 270, the Hang Seng Index has consistently represented between 75% and 80% of the market in terms of both market value and turnover. It was put to us that the index could therefore fairly be regarded as representative of the market.

5. The Hong Kong market has two characteristics which are likely to affect the susceptibility of the index to manipulation (1). First, the dominance of a few companies. Significant movements in the share prices of some of the largest companies have a major impact on the HSI (2). Second, extensive cross-holdings; we were advised that, in terms of market value, the five largest groups accounted for over 43% of the market. Substantial trading

(1) Annex 2 sets out the considerations affecting index future manipulation.

(2) This also makes it easier to construct a small basket of shares that tracks the index fairly accurately, and thus makes arbitrage cheaper and easier.

within these groups would also have a significant impact on the movement of the index. However, a broader-based index would not significantly reduce the impact of sharp price movements in the major stocks. For example, the Hong Kong Index, developed by SEHK on unification, which covers 49 stocks, nevertheless accounts approximately for only 70% of turnover and 80% of total market capitalisation.

6. Another possibility is to move to a non-capitalisation weighted index. Although we have not studied this in detail, a preliminary analysis indicates that price changes in some of the smaller stocks would have a disproportional effect on the index when their importance to investors and the economy is considered. Moreover, because some of these lesser stocks relatively illiquid, their inclusion might actually increase the risks of manipulation and disorderly markets.

7. Our initial conclusion is that the index reflects the inherent structural features of the market itself and, in the circumstances, is probably the best available to track price movements on the stock market. However, this does not necessarily mean that it is the best available basis for an index futures contract.

HSI contract terms

8. The HSI future contract has the following terms :-
- | | |
|-------------------------|---|
| Base | - the Hang Seng Index |
| Contract type | - cash settled futures |
| Contract multiplier | - HK\$50 |
| Minimum fluctuation | - one index point, or \$50 |
| Expiration date | - second last business day in the nearest three consecutive months (called the spot, first and second months) |
| Settlement/expiry price | - the average of quotations for the HSI taken at five minute intervals throughout the last trading day. |

9. Compared with index contracts elsewhere, two relatively unusual features may be noted immediately. First the contract multiplier is small; the result is that, at current prices, the face value of one HSI future contract is one-fifth of a FTSE 100 contract and one-eighth of an S&P 500 contract. Secondly, trading is for one, two and three months out whereas the international norm is for three, six and nine months.

Growth of the market and trading patterns

10. The Hang Seng Index futures contract was introduced in May 1986. As Chart 1 shows turnover rocketed, from 31,070 contracts in May 1986 to a record 601,005 in September 1987. Over the same period, net open interest (3) increased from about 2,000 contracts to 25,000 contracts and gross open interest from 6,000 to 54,000 (4). The rates of growth compared with the value of the underlying index are illustrated below -

<u>Period</u>	<u>Rate of growth</u>			
	<u>HKFE</u>		<u>SEHK</u>	
	<u>Volume</u> (5)	<u>Net Open Interest</u>	<u>Volume</u>	<u>Closing Price of HSI</u>
May '86 - Sept '87	19.0x	13.0x	6.8x	2.2x
Jan '87 - Sept '87	3.2x	1.8x	2.3x	1.5x
Jun '87 - Sept '87	1.8x	1.3x	2.2x	1.3x

11. Futures investors were rushing into the market on account of bullish sentiments. As would be expected, by the middle of every month trading in first month futures

(3) A broker's net open interest is the net of his long and short positions. The net open position of the market is the number of unsettled contracts in the whole market. A broker's gross open interest is the sum of his house and individual client account positions.

(4) See Chart 2.

(5) Definitions: **Volume** is the number of contracts traded during the month in the case of the HKFE, and the number of deals struck in the case of the SEHK.

exceeded spot trading. However, as time passed and in particular from the beginning of 1987, the general bullishness showed through in an increasing disposition to take open positions in the first and second month contracts. During the summer of 1987, the net open position in first month futures would exceed the net open position in the spot month from very early in each month. In consequence, when the market crashed in the week beginning 19 October, most of the open interest was in November rather than October spot futures. Since hedgers and arbitrageurs frequently want to lock into the furthest month out, this could only happen because the speculative interest on the long side of the market was getting braver.

12. Throughout the period, the future's theoretical value was at a premium to the cash price, not least because money was costing less than shares were yielding (another phenomenon of the bull market). Moreover, the future frequently traded at a much higher premium, providing attractive returns for arbitrageurs. Indeed it was suggested to us that returns as high as 30% per annum had sometimes been achieved, against a prime rate of no more than 8% during 1987. The persistence of such high premiums would indicate that the speculative forces on the long side of the market consistently outweighed investors on the short side of the market and may actually suggest a lack of sufficient arbitrageurs to ensure efficient pricing (6).

13. From September onwards, the premium became particularly high. It was put to us that this may have been due to a major build up of long positions in the expectation of a take-over offer for Hong Kong Land, one of Hong Kong's largest and most significant quoted property companies.

14. It is instructive to consider the impact which arbitrage may have had on turnover in the two Exchanges. Given a consistently rising market, it is reasonable to assume that long arbitrage positions were held at least until expiry or even rolled over. Anecdotal evidence suggests roll-overs were fairly commonplace, and became virtually automatic in the run-up to 19 October. On this basis a rough statistical test indicated that, even assuming that all short positions were part of arbitrage programmes, the impact on SEHK daily volumes averaged between 4-6% during the three months up to 16 October and much less during earlier months.

Volatility and margins

15. Stock index futures markets are frequently described as causing an increase in stockmarket

(6) Chart 3 supplied by a broker shows the premium of futures to cash since May 1986.

volatility. The position in Hong Kong leading up to and since the HSI contract was introduced up to end-September has been examined by Andrew F Freris, Head of the Department of Business and Management at the City Polytechnic of Hong Kong (7). A series of tests showed there had not been a statistically significant increase in inter-day volatility but that intra-day volatility had increased.

16. As Chart 4 shows, volatility was well covered by margin levels until the crash.

Position at the time of the crash

17. In considering the passage of events over the week or so of the October market crash, it is important to remember that Hong Kong is 12 hours ahead of New York, where the worldwide decline began; Hong Kong's market therefore closes each day before New York is open. Thus, given the worldwide fall started in the US, Hong Kong was relatively unscathed on 16 October 1987 while New York saw sharp falls. In particular, whereas futures were trading in Chicago at a discount to the cash market in New York towards the end of the day (8), this did not occur in Hong Kong; both the October and November HSI futures traded at a significant premium all day on 16 October 1987 - see Chart 5. Volumes in both contract months showed a slight increase over the 15th.

18. The picture changed on Monday 19 October. The December and November contracts traded limit down at 10.16 hrs and 11.05 hrs respectively after falling 150 points; trading the spot month was halted at 11.27 hrs after falling 180 points. All were suspended for the remainder of the session. The same happened in the afternoon session which commenced at 14.00 hrs; the contracts stopped trading at 14.54 hrs, 14.58 hrs and 15.07 hrs respectively. In consequence, although there was considerably more activity in the spot month than in the November contract because time horizons became shorter, volumes fell dramatically; spot month volumes were almost 40% lower and November contract volumes over 80% lower than the previous week's averages. During the brief periods of trading, the contract traded at a premium to the cash market (see Chart 6).

(7) "The Hang Seng Index Futures and the Stability of the Equity Market in Hong Kong 1984 - 1987", University of Hong Kong, Department of Economics, Discussion Paper Series.

(8) See the Report of the Presidential Task Force on Market Mechanisms.

19. As already reported in Appendix 1, the market did not open again until Monday 26 October, as the HKFE Board was forced to suspend trading by the SEHK's four day closure. In the interim, it became apparent that, on re-opening, the stock market was likely to fall dramatically, that there would be very large margin calls on investors with long positions and that there would be significant defaults.

20. The net open interest in the market at the close of business on 19 October was around 35,000 contracts, equivalent to around \$7bn worth of stock. It was estimated that well over half of the short side of the market was made up of arbitrage positions and that in terms of dollar values, there was an overhang of between \$4bn and \$6bn of stock purchased in connection with arbitrage programmes. If the futures market collapsed, these positions would have to be liquidated depressing stock prices even further, with all the consequences to the economy that that might bring. One feature of the rescue package described in Appendix 1 to the Report was accordingly that long arbitrage positions should be unwound gradually. It seems this was achieved.

21. When the market re-opened at 11.00 a.m. (9) on Monday 26 October, trading in the spot month was permitted without limit but 300 point limits were put on the November and December contracts. All the volume was in the spot month, with November and December closing limit down without trading. As Chart 7 shows, the October future rapidly fell to a large discount to the cash market, which may have brought buyers into the ring.

Make-up of the market

22. The spectacular growth in the market came almost entirely from increased institutional and retail client interest. Clients accounted for nearly all the business on both sides of the market, as the following shows for the net open long positions : -

<u>Daily Net Open Interest</u> (Long side)			
	<u>House account</u>	<u>Clients</u>	<u>Total</u>
2 June '87	1195 (7%)	16,326 (93%)	17,521
1 July '87	942 (5%)	18,748 (95%)	19,690
3 August '87	1418 (7%)	17,851 (93%)	19,269
1 September '87	2208 (10%)	22,588 (90%)	24,796
1 October '87	1081 (4%)	23,870 (96%)	24,951
16 October '87	2193 (6%)	34,490 (94%)	36,683

(9) An hour later than usual.

23. Save in one other important respect, it is apparent that the long and short sides of the market were completely different in character. The long side was almost wholly speculative and had a large retail element; there were many reports of taxi-drivers and amahs playing the futures market. The short side was largely institutional, with 50% or more being arbitrageurs.

24. But on both sides of the market, the business was concentrated in the hands of a few brokers. Three brokers accounted for over 50% of the net long positions (out of a total of seventy-five net long brokers); and five brokers accounted for nearly 90% of net short positions (out of a total of twenty-seven net short brokers). Some of these brokers held large positions on both sides, but still had resultant large net positions. They were therefore particularly exposed to a major collapse.

25. Finally, roughly 50% of the long positions were held by a single client and associates. In short, there was a major risk concentration problem, with the market depending on the ability of a few brokers and investors to support very large positions relative to the market, and, in some case, their net worth.

26. The position during the week of 19 October was therefore as follows. The longs were exposed to a sharp decline in futures prices, particularly given lax margin collection and extensive credit extensions, thereby raising the spectre of massive defaults. The shorts were exposed because first, they might not be able to collect their winnings from the futures market to pay their clients and second, a significant proportion of their clients were arbitrageurs and therefore held stock market positions which were rapidly diminishing in value. It has also been suggested to us that as prices rose, some clients with short positions met their futures market variation margin commitments by borrowing against stock holdings which were purchased in the first place through margin facilities. In consequence, when the crash came, brokers on the short side also faced the prospect of client defaults in so far as they are not able to cover their stock losses from their futures profits if the long position holders defaulted.

27. To sum up, most of the major players in the market had substantial exposures in the event of a market collapse.

HANG SENG INDEX CONSTITUENTS
(as at end April 1988)

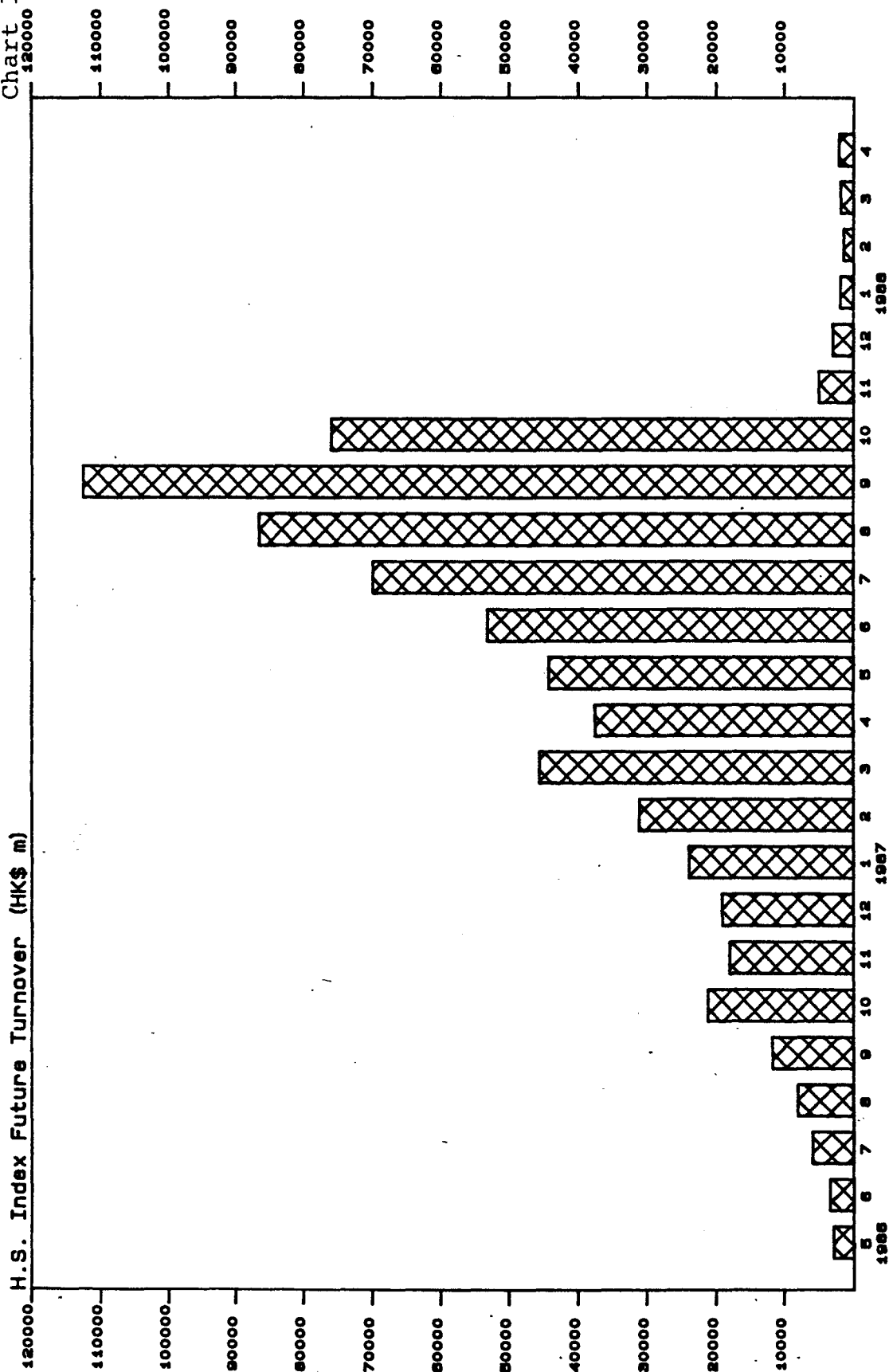
<u>Company</u>	<u>Effect on HSI (in points)</u>	<u>% of HSI Market Capitalisation</u>
The Bank of East Asia Ltd.	0.06	0.75
Hang Seng Bank Ltd.	0.45	4.60
The Hongkong and Shanghai Banking Banking Corporation	1.69	8.61
Jardine Strategic Holdings Ltd.	0.22	1.63
Finance		15.59
China Light & Power Co. Ltd.	0.75	5.29
The Hong Kong & China Gas Co. Ltd.	0.29	1.85
Hongkong Electric Holdings Ltd.	0.59	3.49
Hong Kong Telecommunications Ltd.	3.12	17.03
The Kowloon Motor Bus Co. (1933) Ltd.	0.21	1.03
Utilities		28.69
Cheung Kong (Holdings) Ltd.	0.71	4.08
Hang Lung Development Co. Ltd.	0.37	1.53
Henderson Land Development Co. Ltd.	0.47	1.94
The Hongkong Land Co. Ltd.	0.81	5.24
Hongkong Realty and Trust Co. Ltd.	0.07	0.49
Hysan Development Co. Ltd.	0.28	0.98
New World Development Co. Ltd.	0.73	2.91
Sun Hung Kai Properties Ltd.	0.93	3.85
Tai Cheung Properties Ltd.	0.06	0.36
Properties		21.38
Cathay Pacific Airways Ltd.	0.93	5.15
Cavendish International Holdings Ltd.	0.47	2.42
Dairy Farm International Holdings Ltd.	0.21	1.42
Green Island Cement (Holdings) Ltd.	0.07	0.38
Hong Kong Aircraft Engineering Co. Ltd.	0.12	0.56
The Hongkong and Shanghai Hotels Ltd.	0.16	1.04
HK-TVB Ltd.	0.27	1.61
Hutchison Whampoa Ltd.	0.98	6.37
Jardine Matheson Holdings Ltd.	0.40	1.93
Mandarin Oriental International Ltd.	0.10	0.70
Miramar Hotel & Investment Co. Ltd.	0.15	0.85
Swire Pacific Ltd.	1.02	6.58
The Wharf (Holdings) Ltd.	0.56	3.04
Winsor Industrial Corporation Ltd.	0.08	0.55
World International (Holdings) Ltd.	0.33	1.74
Commercial & Industrial		34.34
		<u>100.00</u>
		=====
		<u>100.00</u>
		=====

INDEX CONSIDERATIONS

We understand that the US authorities weigh the following considerations in addressing whether an index future will be exposed to manipulation :-

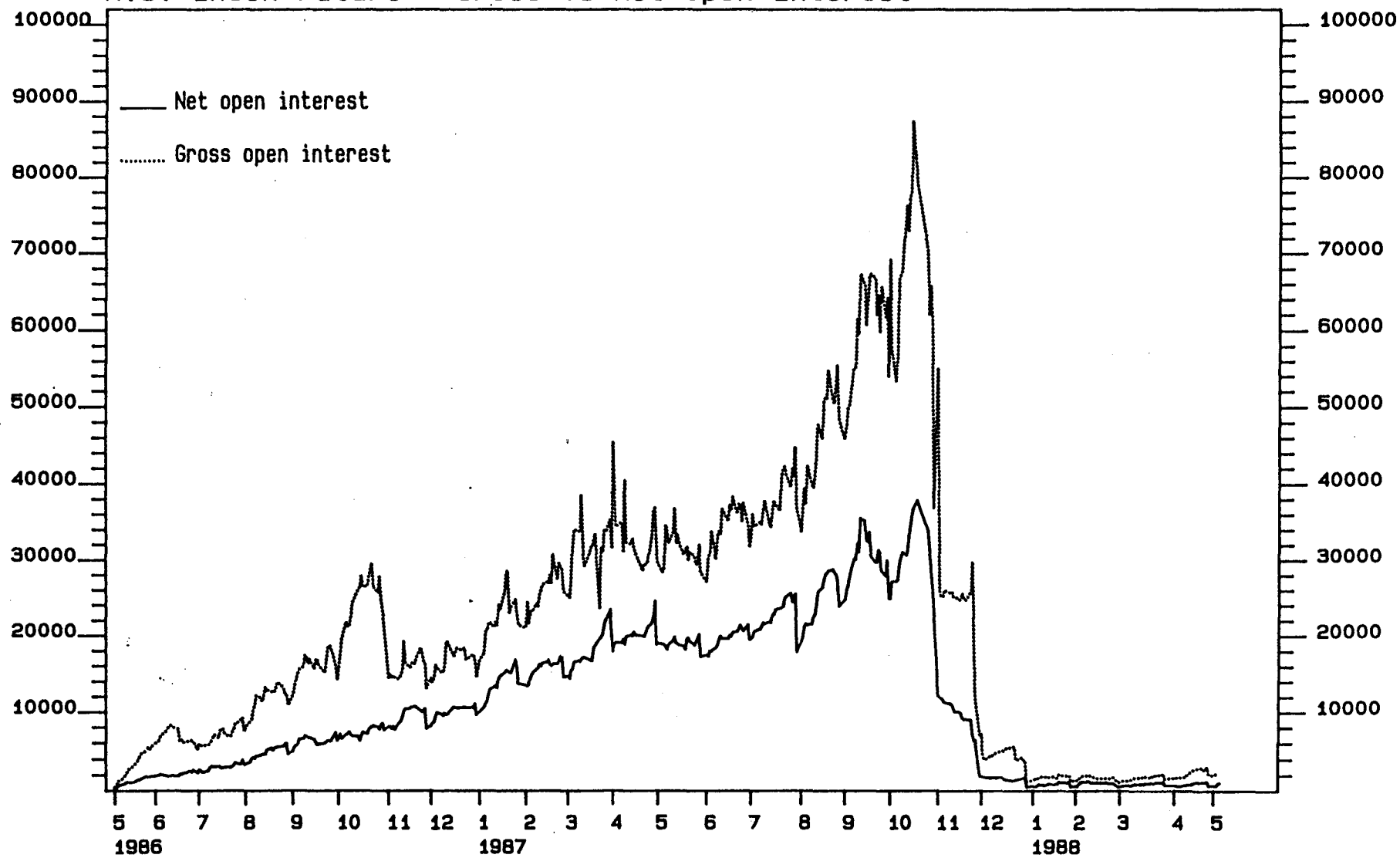
- (a) the number of stocks composing the index - a large number usually makes manipulation of the index, or through it, of any stock it comprises less feasible;
- (b) capitalisation - total shares outstanding of component stocks times price per share. The larger this number is, the larger is the investment required for any manipulative attempt and thus the riskier the attempt becomes;
- (c) depth and liquidity of secondary market - strong showings in these areas (measures primarily by volume and volatility) also makes manipulation a much larger, more hazardous and impractical undertaking;
- (d) diversification - diversity of issuers and industries correlates to pricing independence among component stocks and so renders manipulation more difficult; and
- (e) weighting - a system of calculating index value which gives greater weight to the prices of those stocks which are individually less subject to manipulation (due to factors like capitalisation, depth and liquidity). This type of weighting will make the index as a whole less subject to manipulation, provided the weighting does not result in the index being dominated by one or a few stocks, thus raising the diversification criterion.

Chart 1



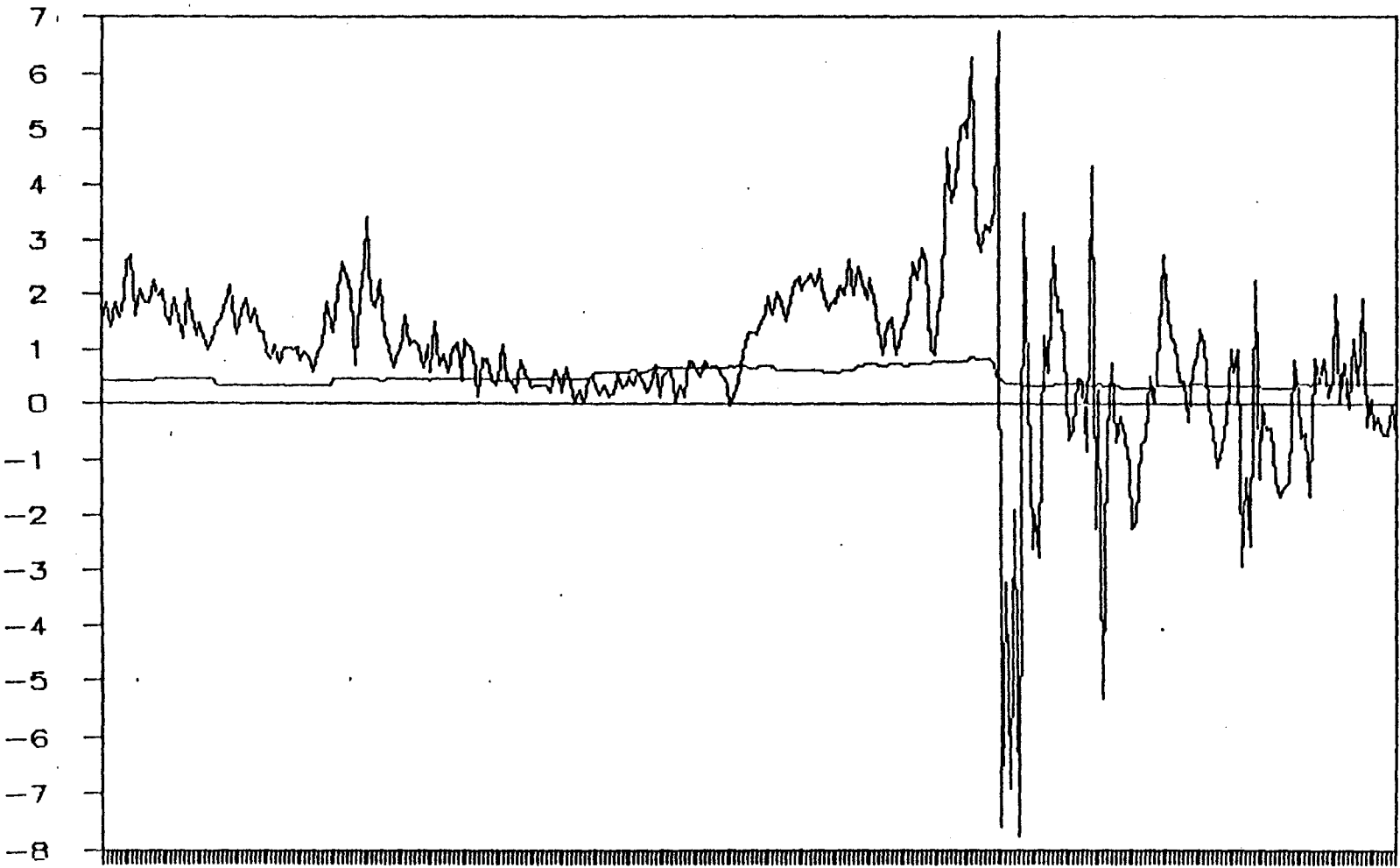
H.S. Index Future - Gross Vs Net Open Interest

Chart 2



Daily Premium of HSI

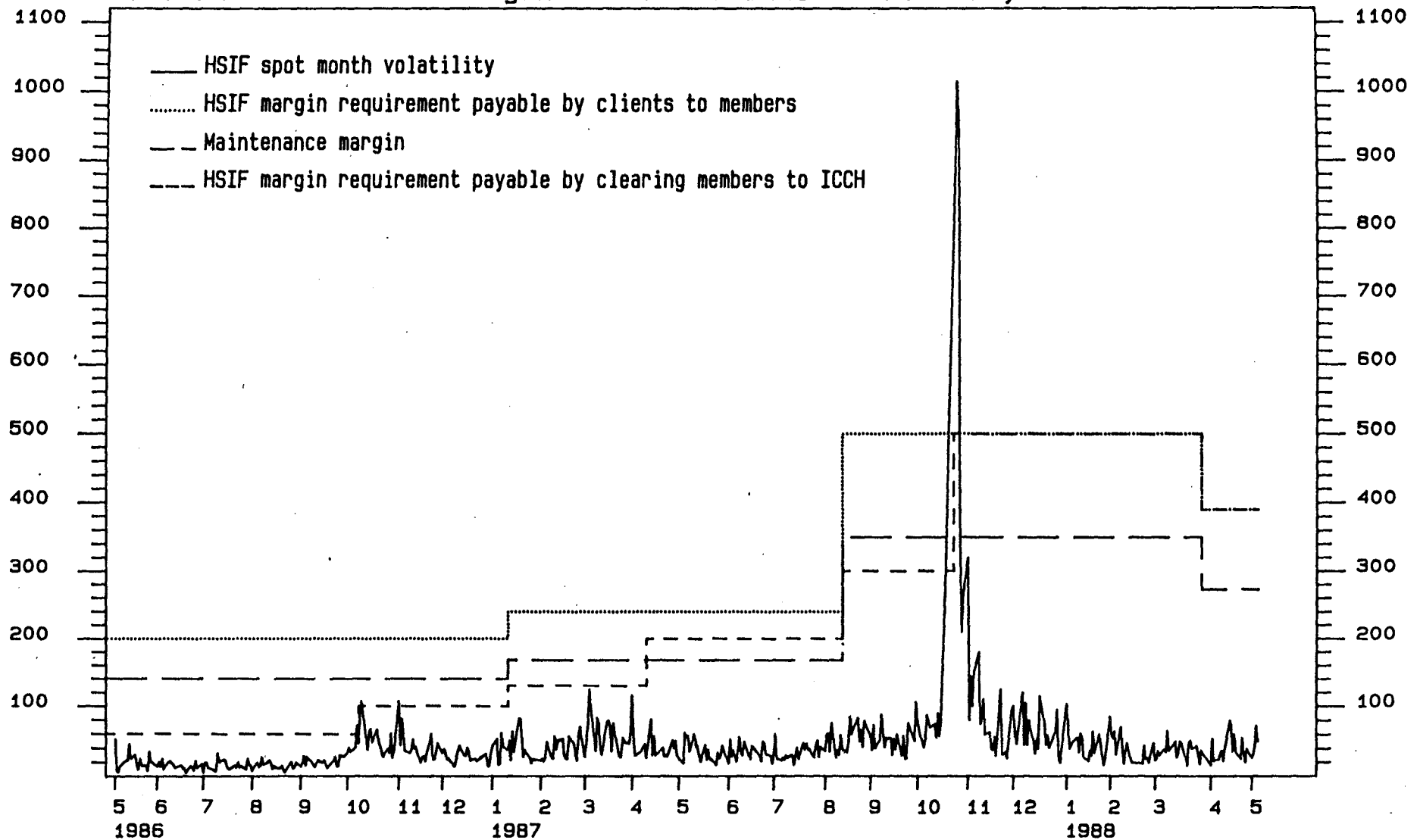
Chart 3

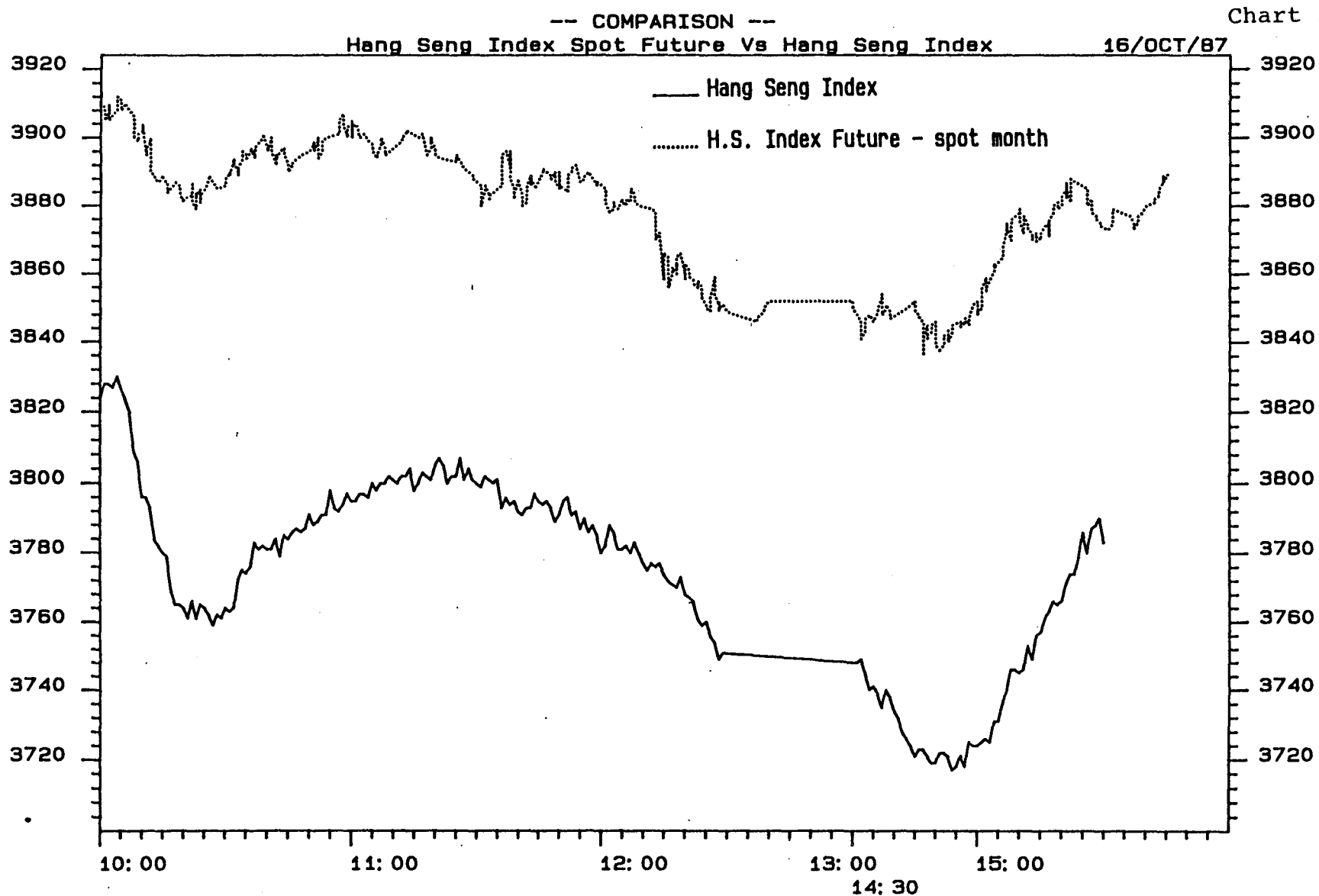


December 86 — March 88

Chart 4

H.S. Index Future - Margin Levels Vs Index Volatility

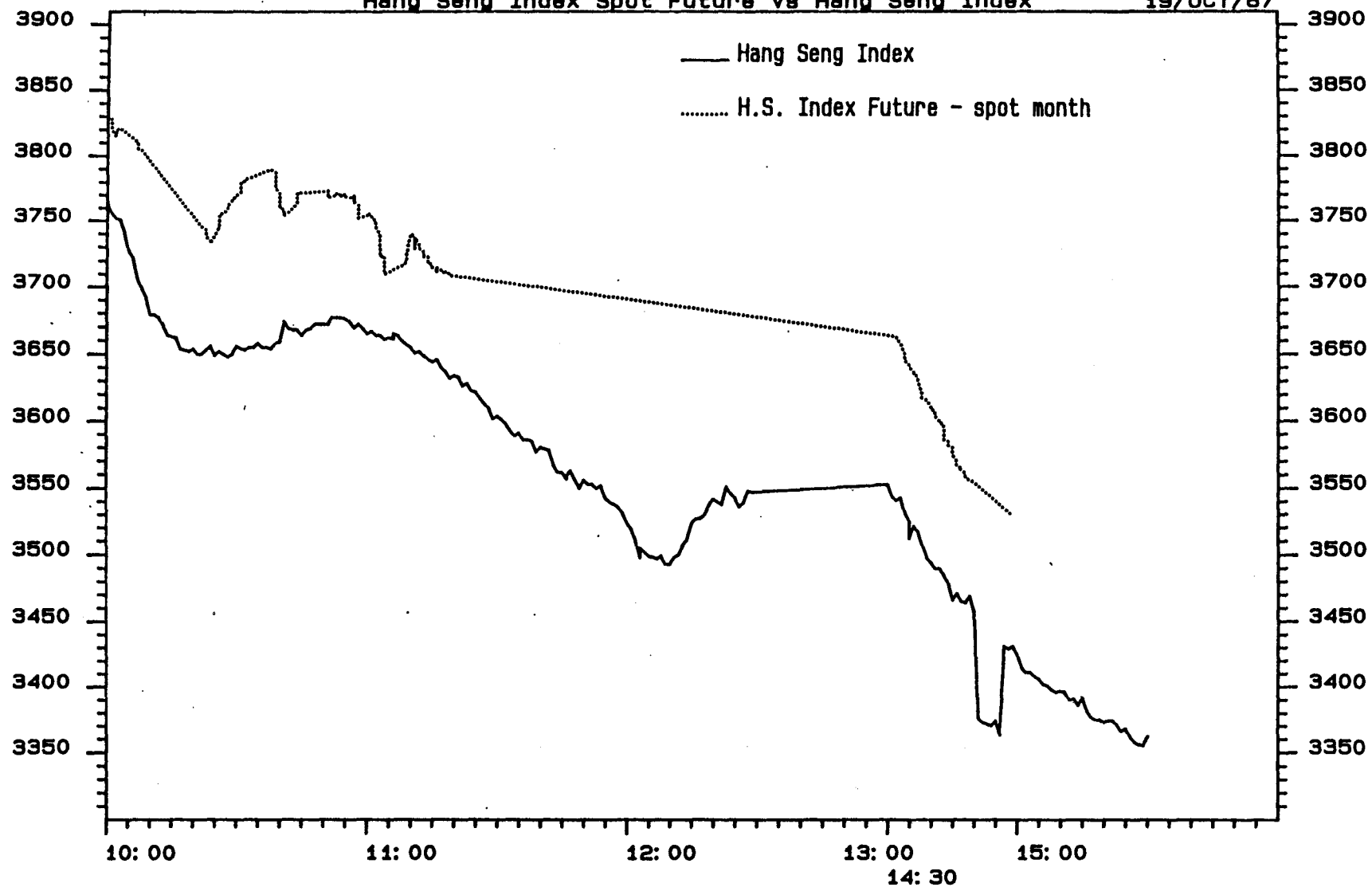




-- COMPARISON --

Hang Seng Index Spot Future Vs Hang Seng Index

19/OCT/87

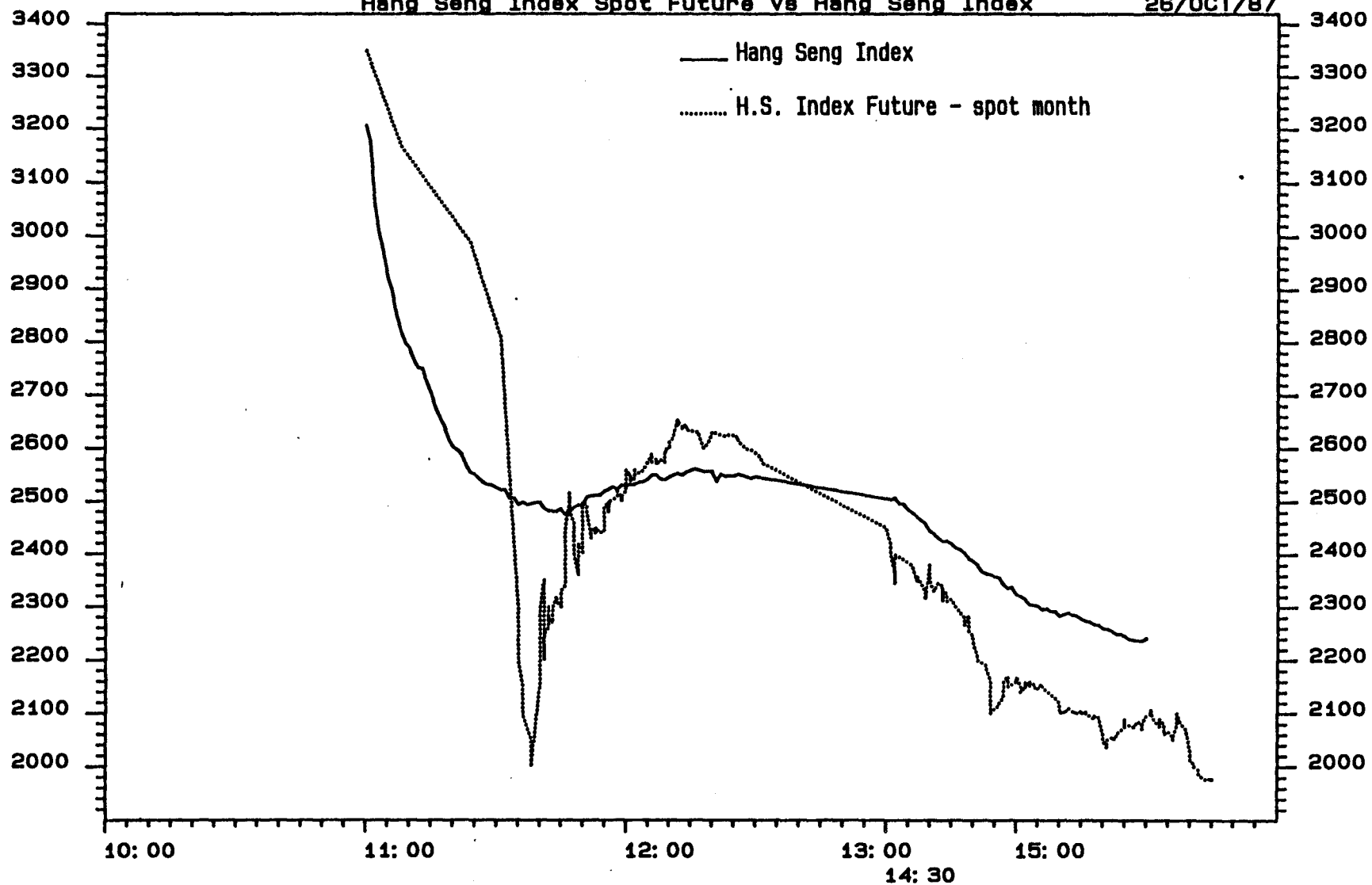


-- COMPARISON --

Chart 7

Hang Seng Index Spot Future Vs Hang Seng Index

26/OCT/87



APPENDIX 24

THE HONG KONG FUTURES EXCHANGE REFORMS FOR FUTURES TRADING IN HONG KONG

In December 1987, the Hong Kong Futures Exchange Limited (HKFE) issued a package of reforms for the Hang Seng Index (HSI) market which had been agreed with ICCH (Hong Kong) Limited (ICCH) and the Hong Kong Futures Guarantee Corporation (FGC). In most cases, implementation is already underway. The main rule changes currently in place are described below.

EXCHANGE

Client relations

- (a) Brokers are now required to ensure that their clients are fully aware of the risks of trading futures and acknowledge this by signing and returning a form to the broker [Rule 431].
- (b) New rules have been introduced requiring members to know the identity of their clients including beneficial ownership and to establish their financial position prior to trading [Rule 431A].
- (c) Members must state in each Client Agreement how long the client is given to meet margin calls and that the member will be obliged to close out a position if calls are not met [Rule 431(ii)(h)]; the extension of credit by brokers was already banned under Rule 442.

Capital requirements

- (d) Full members and firms trading in the HSI market now have to have minimum paid-up capital of \$5 million. This was introduced from 31 March 1988 but the Exchange may give case-by-case extensions until the end of the year [Rules 307, 321 and 325A].
- (e) For all other existing markets the minimum paid-up capital has been increased from \$1 million to \$2 million [Rule 321].

Locals (Floor Traders)

- (f) The Exchange has introduced a new category of floor traders who may trade for their own account only. As they are prohibited from trading for clients they are subject to a low \$1/2 million minimum capital requirement. But position limits will be applied because of the intra-day exposures they might take [Rules 325B and C].

Reporting

- (g) Members are obliged to make a monthly financial return to the Exchange within 14 days of the month end; returns were previously quarterly [Rule 418(b)].
- (h) Members are now obliged to notify the Exchange if a client misses two consecutive margin calls [Rule 441A].
- (i) Members are now required to report to the Exchange any client or house account large open positions. In the first instance brokers may identify clients by numbers but, when specifically requested, the identities and beneficial owners must be provided [Rules 441B and 525B]. The current reporting trigger is 100 net open positions in any contract month.

Limits

- (j) Position limits based, inter alia, on a firm's net worth may now be imposed on open HSI positions [Rule 525A]. As yet the Exchange has imposed limits only on those non-clearing members who have been given a temporary waiver from the minimum capital requirements. Limits are roughly 50 net open positions for each \$1 million of capital; this is around \$6.2 million at current values or, with margins at 15%, an estimated exposure of around 100% of capital. (Clearing members are covered by ICCH rules - see below.)
- (k) Absolute speculative position limits may also be imposed, again under Rule 525A. This has not so far been used.

ICCH

- (a) The minimum net worth requirement for General Clearing Members has been raised to \$15 million by 31 March 1988 and \$25 million by the year-end; the equivalent figures for Individual Clearing Members are \$5 million and \$10 million.
- (b) It is proposed that associations or co-operatives should be able to acquire General Clearing Member status. As yet, none has.
- (c) Margins are now collected on a gross basis. It has been indicated that original margin levels might be reduced once Clearing Members have increased their capital and position limits have been introduced.
- (d) The number of open positions a General Clearing Member or Individual Clearing Member may hold is now limited in relation to its net worth.

APPENDIX 25

REGULATORY FRAMEWORK OF THE SECURITIES AND COMMODITY FUTURES INDUSTRIES IN HONG KONG

Introduction

Regulation of the securities and commodity futures industries in Hong Kong has its historical origins in the stock market boom and collapse of the early 1970's. Prior to 1974, the securities industry was only loosely regulated under the relevant provisions of the Companies Ordinance, the Stamp Ordinance and the Stock Exchange Control Ordinance.(1)

Legislation and rules

2. The business of dealing in securities and commodities futures and of giving advice thereon is basically governed by the following legislation and rules -

- (a) Stock Exchanges Unification Ordinance, Cap. 361;
- (b) Securities Ordinance, Cap. 333;
- (c) Protection of Investors Ordinance, Cap. 335;
- (d) Commodity Exchanges (Prohibition) Ordinance, Cap. 82;
- (e) Commodities Trading Ordinance, Cap. 250;
- (f) Companies Ordinance, Cap. 32; and
- (g) Memorandum and Articles of Association as well as Rules (and Regulations) of -
 - (i) the Stock Exchange Hong Kong Limited;
 - (ii) the Hong Kong Futures Exchange Limited;

(1) This was enacted in 1973 to prevent the establishment of further stock exchanges in addition to the four exchanges which then existed.

(iii) ICCH (Hong Kong) Limited; and

(iv) the Hong Kong Futures Guarantee Corporation Limited.

In addition, there are regulations made pursuant to the above Ordinances governing specific issues like accounts and audit, investigations, etc.

Regulatory structure

3. These legislation and rules provide for the establishment of a three-tier regulatory structure for the prudential supervision of the securities and commodity futures industries, namely -

- (a) the Securities Commission and the Commodities Trading Commission;
- (b) the Commissioner for Securities and Commodities Trading and his Office; and
- (c) the Stock Exchange of Hong Kong Limited, and the Hong Kong Futures Exchange Limited together with its clearing house and guarantee corporation.

A. The securities industry

The Securities Ordinance

4. The business of dealing in securities and of giving related investment advice has, since 1974, been regulated by the Securities Ordinance. This Ordinance is essentially based on the New South Wales Securities Industry Act 1970, which in turn evolved from the United States.

5. The main impetus for the promulgation of the Securities Ordinance came from the stock market boom and crash of the early 1970's and arose out of the 1971 Report of the Companies Law Revision Committee (CLRC). This drew heavily upon the Jenkins Committee Report in England and recommended, inter alia -

- (a) the licensing of dealers, investment advisers and portfolio managers and their representatives;

- (b) the establishment of a licensing authority i.e. the Commissioner for Securities, to be supported by his own staff;
- (c) the establishment of a Securities Advisory Board to deal with appeals and conduct of business;
- (d) some restrictions on the proliferation of stock exchanges;
- (e) the establishment of a Compensation Fund; and
- (f) various provisions relating to prospectuses, takeovers, mutual funds, unit trusts, etc.

6. The Securities Ordinance provides for the establishment of a Securities Commission and brings all stock exchanges under its supervision. It provides for the creation of a Commissioner for Securities as the executive arm of the Securities Commission and vests in the Commissioner certain direct powers, particularly in the registration of securities dealers and advisers. It requires dealers to keep proper accounts and records and empowers the Commissioner to appoint an auditor if necessary. It obliges the stock exchanges to provide funds to compensate persons who suffer from defalcations by stockbrokers. It confers powers of investigation on the Commissioner and on inspectors appointed by the Commission in relation to suspected or alleged fraud, etc. It seeks to protect investors by creating certain offences in relation to improper practices connected with dealings in securities, for example, hawking of securities, short selling and option and forward trading. It further provides that investors may be compensated in damages for losses occasioned by certain improper trading practices such as creating false markets. It also contains provisions for the inquiry into suspected insider dealing by an Insider Dealing Tribunal, though it does not make insider dealing an offence.

The Securities Commission

7. The Securities Commission was established in 1974 under the Securities Ordinance. It is a body corporate consisting of at least seven members including the Commissioner for Securities, the Registrar of Companies and other members drawn from the professions and the industry. All members, including the Chairman, are appointed by the Governor for a period of two years, subject to renewal.

8. The functions of the Commission, which are laid down in the Ordinance, include -

- (a) to advise the Financial Secretary on all matters relating to securities;
- (b) to apply the Securities Ordinance and the Protection of Investors Ordinance;
- (c) to report any insider dealing cases to the Financial Secretary;
- (d) to supervise the stock exchanges; and
- (e) to protect investors and ensure fair practices prevail.

9. The Commission has five committees dealing respectively with -

- (a) takeovers and mergers;
- (b) the licensing of unit trusts;
- (c) authorization of advertisements relating to paper gold schemes;
- (d) Bills of Exchange and Certificates of Deposit; and
- (e) investment-linked life assurance schemes and pooled provident funds.

Also, as laid down in the statute, the Commission has a Compensation Fund Committee and a Disciplinary Committee, each of which has two members nominated by the Stock Exchange of Hong Kong Limited (SEHK).

10. The constitution and rules of the SEHK, including any amendments thereto, have to be approved by the Commission. The Commission may, after consultation with the SEHK, make rules in respect of listing of securities, suspension of dealings, new offers of shares to the public, membership of the Exchange, etc.

11. Under the Securities Ordinance, the Governor may give directions to the Securities Commission or Commissioner in the exercise or performance of their powers, duties and functions. Furthermore, the Financial Secretary may require the Commission to furnish him with reports on current or proposed policy.

12. The Commission may withdraw recognition of the SEHK as the Exchange Company or may order suspension of trading under certain circumstances.

The Commissioner of Securities

13. The Commissioner for Securities is a civil servant appointed by the Governor to "carry out the directions of the Commission in relation to the exercise of its functions" (S. 7 of the Securities Ordinance, q.v.). The Commissioner is therefore the executive arm of the Securities Commission. In addition, the Commissioner is given a wide range of statutory responsibilities in connexion with dealings in securities, in particular, the registration of dealers in securities, dealers' representatives, investment advisers and representatives of investment advisers. Furthermore, the Commissioner has the power to close the Exchange and to order a suspension of dealings on the Exchange.

The Stock Exchange of Hong Kong Limited

14. The Stock Exchanges Unification Ordinance (SEUO) was enacted in 1981 to provide for an exchange company to operate a unified stock exchange. The unified Stock Exchange, operated by the SEHK, came into being in 1986 on the amalgamation of Hong Kong's four previous exchanges. The Exchange is owned by its members and managed by a Committee elected by the members. The SEUO governs the relationship between the Commissioner for Securities and his Office, the Securities Commission and the Stock Exchange of Hong Kong Limited.

15. The SEUO governs the Memorandum and Articles of Association of the SEHK. It also provides that amendments to the Memorandum and Articles of Association or Rules of the SEHK must be approved in writing by the Securities Commission. While the Securities Commission has no power to direct the SEHK to amend its Memorandum and Articles of Association, it has the power to direct an amendment to the Rules of the SEHK. The SEUO sets out the Rules for minimum eligibility of individual and corporate members of the SEHK and confers powers on the SEHK to make Rules with regard to listing, capital requirements of members and other matters relating to the operation and management of the SEHK.

16. The Memorandum and Articles of Association of the SEHK provides for the regulation and conduct of the business of a stock exchange. The Articles of Association set out, inter alia, the provisions relating to eligibility for membership, the constitution and powers of the Committee of the Exchange and provisions dealing with the disqualification of Committee members.

17. Pursuant to the SEUO and its Memorandum and Articles of Association, the SEHK has prescribed Rules to govern the official listing of securities on the Exchange

and to regulate the administration of the Exchange. Rules have also been developed on membership, financial and accounting requirements by members, trading rules, code of conduct, disciplinary matters, payment of fees and charges, and compensation. These rules also provide for action to deal with any emergency.

18. New issues and offers to the public of shares, whether or not listed, are also subject to the prospectus registration requirements of the Companies Ordinance and the general restrictions of the Protection of Investors Ordinance on the making of invitations to the public with respect to securities and other investments.

B. The Commodity futures industry

The Commodities Trading Ordinance

19. The Commodity Exchange (Prohibition) Ordinance was enacted in 1973 to restrict the establishment and operation of commodity exchanges.

20. In 1976, the Commodities Trading Ordinance was promulgated to provide for the establishment of a commodity exchange and to control trading in commodity futures contracts.

21. The Ordinance provides for the establishment of a Commodities Trading Commission, and vests in the Governor-in-Council powers to license any company to establish and operate a Commodity Exchange. Such a licence was given to the Hong Kong Commodities Exchange Limited in 1977. The licence was renewed in 1984 when the Exchange Company was re-constituted as the Hong Kong Futures Exchange Limited (HKFE) with Government-appointed membership of the Board of the Company.

22. The Ordinance also provides for the registration of commodity dealers, advisers, dealers' representatives and advisers' representatives. It requires dealers to keep proper accounts and records and empowers the Commissioner to appoint an auditor if necessary. It deals with the trading practices for specified commodities namely, cotton, sugar, soyabeans, gold and Hang Seng index futures. It also seeks to protect investors by creating certain offences in relation to improper practices connected with dealing in commodities, for example, hawking of futures contracts and false trading. It provides for inquiries into allegations of misconduct on the HKFE, and obliges the HKFE to provide funds to compensate persons who suffer from defalcations by commodity futures brokers.

The Commodities Trading Commission

23. The Commodities Trading Commission was established in 1976 under the Commodities Trading Ordinance. Like the Securities Commission, it is a body corporate. The Commission consists of not less than seven members, including the Commissioner for Securities and the Chairman of the Securities Commission, who is automatically the Chairman. All members are appointed by the Governor for a period of two years, subject to renewal.

24. The functions of the Commission include -

- (a) to advise the Financial Secretary on matters relating to commodity futures contracts;
- (b) to enforce the Commodities Trading Ordinance;
- (c) to supervise the activities of the Futures Exchange; and
- (d) to protect those who trade in futures contracts.

25. The Commission has an Investigations Sub-committee to inquire into any report of irregularity or suspected irregularity by the Exchange Company or the Clearing House and may appoint a Disciplinary Committee to determine any allegation. That Committee also acts as an Appeals Committee to determine appeals against decisions of the Commissioner. The Commission also administers the statutory compensation fund through the Compensation Fund Committee.

26. The use of any clearing house and guarantee corporation by the HKFE has to be approved by the Commission. Also, the constitution and rules of these three bodies, including any amendments thereto, have to be approved by the Commission.

27. The Governor may give directions with respect to the exercise or performance by the Commodities Trading Commission or Commissioner of their powers, duties and functions under the Commodities Trading Ordinance and may direct closure of the Exchange in an emergency or crisis situation.

28. The Commission also has powers to close the Exchange and to revoke its licence to operate in certain circumstances.

The Commissioner of Commodities Trading

29. In addition to performing the specific functions conferred on him by the Securities Ordinance, the Commissioner for Securities is also the Commissioner for Commodities Trading under the Commodities Trading Ordinance. Although the Commodities Trading Ordinance does not say so in terms, the Commissioner for Commodities Trading operates as the executive arm of the Commodities Trading Commission.

30. The Office of the Commissioner for Securities and Commodities Trading, which is staffed by civil servants, is thus the primary executive agency for the prudential supervision of the securities and commodity futures industries in Hong Kong.

The Hong Kong Futures Exchange Limited

31. Like the SEHK, the HKFE comes under the supervision of the Commissioner's Office in his role as the Commissioner for Commodities Trading, under the direction of the Commodities Trading Commission. At present, the HKFE trades the Hang Seng index futures contract as well as futures contracts in gold, soyabeans and sugar.

32. The Memorandum and Articles of Association of the HKFE establish a commodity exchange or exchanges in Hong Kong and provide for the management and control of the HKFE. The Articles of Association lay down the constitution and powers of the Board of the Exchange, and provides for the disqualification of Directors.

33. The HKFE has prescribed Rules and Regulations to govern the administration, membership, code of conduct and trading rules on each market conducted by the Exchange.

The ICCH (Hong Kong) Ltd. and the Hong Kong Futures Guarantee Corporation

34. In addition to the HKFE's Rules and Regulations, the ICCH (Hong Kong) Limited and the Hong Kong Futures Guarantee Corporation also lay down Rules governing the registration of contracts, payment of deposits and margins, security for deposits and margins, invoicing back, indemnification of members' liability and the like.

APPENDIX 26

PROPOSED POWERS OF THE SECURITIES COMMISSION

POWERS OVER INDIVIDUAL FIRMS

Licensing

- . To require any relevant information from the applicant firm and also directly from any of its directors, controllers and managers;
- . to require an applicant to provide an accountant's (or other expert's) report on information contained in or relevant to the application;
- . to be able to take into account any matters concerning business related to the applicant or its controllers; and
- . to obtain information from, and provide information to, other public bodies and financial supervisors, here and overseas.

Revocation, suspension, restrictions

- . To revoke, suspend or impose restrictions on a licence; and
- . to freeze the business.

Prudential requirements

- . To set capital and liquidity rules;
- . to set concentration limits and reporting triggers;
- . to set margin requirements; and
- . to set conduct of business rules (this should be used sparingly as the emphasis should be on codes).

Directions

- . To give directions on the conduct of the business where necessary to protect investors.

New major shareholders

- . . To vet and give prior approval (or not) to proposed major new shareholders or controllers of dealing companies.

Information

- . To require information, books and records from the licensed firms and to appoint an accountant to report on information provided. Such powers should be extended to related companies and parties; and
- . to have a right of entry to obtain such information.

Investigations

- . To appoint inspectors to report on the nature, conduct, ownership and control of the business. Again, such powers should be extended to related companies.

Applications to Court

- . To apply for injunctions to freeze assets while an investigation is proceeding;
- . to apply for an order requiring repayment of clients' moneys; and
- . to apply for a winding up or bankruptcy order if a firm is insolvent or it would be just and equitable or in the interests of existing or prospective investors or in the public interest for a firm to be wound up.

POWERS OVER EXCHANGES AND CLEARING HOUSES (CH)

Constitution

- . To revoke authorisation;
- . to require information in connection with authorisation (in the case of new clearing houses etc);
- . to approve changes in the Memorandum and Articles; and
- . to direct changes in the Memorandum and Articles.

Governing body

- . To ensure the election/appointment systems operate fairly;
- . to ensure any independent members are genuinely independent;
- . to ensure the "broadly based and representative" requirements are satisfied;

- . to ensure that all candidates/members are fit and proper to hold their respective positions; and
- . to approve the terms of reference and role of the chairman and chief executive.

Management

- . To require changes in the day-to-day running of the Exchange/CH;
- . to appoint Securities Commission officials or outside advisers to run the Exchange/CH in an emergency; and
- . to exercise any of the powers of the Exchange/CH.

Operation

- . To give directions on the management of the Exchange;
- . to approve or direct changes in the rule books;
- . to suspend trading in a particular security;
- . to suspend or cancel an SEHK listing;
- . to approve a new product or contract (e.g. a new futures contract or options); and
- . to set Exchange/CH margin requirements.

Member surveillance

- . To require information about members and to directly deal with problems in a member firm if remedial action is not undertaken by the Exchange/CH.

Surveillance of the Exchanges/CHs

- . To conduct periodic and/or ad hoc reviews and investigations;
- . to require any information relevant to such reviews; and
- . to appoint accountants (or other independent experts) to review and report on a particular area (or areas) of the institutions operations, management etc.

APPENDIX 27

AUTHORISED SECURITIES INTERMEDIARIES (as at end November 1987)

	<u>Dealers</u>	<u>Advisers</u>
Registered Intermediaries	1105	635
Representatives	2571	326
Exempt Intermediaries	245	16

A. Registered Dealers (1105) -

	<u>Total</u>	<u>Members of SEHK</u>	<u>Not Members of SEHK</u>	<u>Also registered as investment advisers</u>
Corporations	171	83	88	62
Directors of corporations	265	0	265 ⁽¹⁾	82
Sole traders	608	594	14	11 ⁽³⁾
Partners of partnerships ⁽²⁾	61	61	0	0
Total	1105 ⁽⁴⁾	738	367	155

(1) 122 were directors of companies who were not SEHK members and 143 were directors of SEHK member companies.

(2) 30 registered dealing partnerships.

(3) Dealers trading as sole-proprietors who are also directors of registered advisory companies.

(4) Of the 1105 registered dealers, 82 were also registered commodity dealers.

B. Exempt Dealers (245) -

Licensed banks	103
Trustee companies	18
Licensed/registered DTCs	66
Unit trust managers	26
Others	32
	<hr/>
Total	245
	<hr/>

C. Registered Advisers (635) -

	<u>Registered advisers</u>	<u>Also dealers</u>
Companies	249	62
Directors of companies	363	93 ⁽⁷⁾
Sole traders	22	-
Partners of partnerships ^{(5) (6)}	1	-
	<hr/>	<hr/>
Total	635	155
	<hr/>	<hr/>

(5) There was one registered investment advisers partnership under s.49B.

(6) The one general partner is a corporation. There are other limited partners but they do not need to register.

(7) Including 82 directors who are also directors of registered advisory corporations and 11 who act as sole trader registered dealers.

D. Registered representatives -

Acting for	<u>Dealers representatives</u>	<u>Advisers representatives</u>
Companies	863	318
Partnerships	181	-
Sole traders	1527	8
	<hr/>	<hr/>
Total	2571	326
	<hr/>	<hr/>

Source : Office of the Commssioner for Securities and
 Commodities Trading

APPENDIX 28

EXAMPLES OF CONDUCT OF BUSINESS RULES

(a) Firm/customer relation rules :-

- (i) firms to know the personal and financial circumstances of their customers and to recommend only what is suitable;
- (ii) customers to be fully informed of the risks involved in what is proposed;
- (iii) best advice i.e. that the product recommended will meet the customer's needs no less advantageously than any other product; transacted at the best price quoted at the time of transaction;
- (v) business to be conducted within the framework of a customer agreement;
- (vi) firms to disclose material interests, commissions, rebates, product particulars etc to their customers;
- (vii) proper advertisements; and
- (viii) firms to provide contract notes, confirmation notes and periodic statements.

(b) Firm's conduct rules :-

- (i) the dealer to be completely independent in execution and giving advice; or to disclose any constraints on the exercise of independent judgement such as relationships with the company concerned etc;
- (ii) circumstances under which the aggregation of customers' orders is permitted and fair allocation of transactions between customers;
- (iii) no dealing in advance of research recommendations and customer orders;

- (iv) customers come first, i.e. subordination of firm's interests, including limitations on dealings by the firm, its officers and employees;
- (v) records of relations with customers to be kept; and
- (vi) protection for customers' assets, whether money or documents of title - i.e. segregation.

APPENDIX 29

ENQUIRIES AND COMPLAINTS RECEIVED BY THE OFFICE OF THE COMMISSIONER FOR SECURITIES AND COMMODITIES TRADING

(2 January 1987 to 19 March 1988)

	<u>Period</u>	<u>Number</u>	<u>Monthly Average</u>
(1)	2 January 87 - 31 July 87	149	21
(2)	1 August 87 - 16 October 87	122	49
(3)	19 October 87 - 24 December 87 ⁽¹⁾	702	351
(4)	28 December 87 - 19 March 88 ⁽²⁾	37	15

In addition the OCS received 490 complaints lodged with the Office of the Members of the Executive and Legislative Council. All these complaints were in respect of the Hang Seng Index Futures contract; some had already been reported to the OCS.

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- (1) The high number of complaints was generated by the market crash. Of these, 217 were related to settlement of stock transactions, 223 were related to the futures contract and 201 were general and miscellaneous enquiries.
- (2) The sharp decrease in the number of complaints reflected reduced turnover and activity on the Stock and Futures Exchanges.

Source: Office of the Commissioner for Securities and
Commodities Trading

APPENDIX 30

LISTING MATTERS HANDLED BY THE OFFICE OF THE COMMISSIONER FOR SECURITIES (1983 to 1987)

(A) New Listing Proposals

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Public offers	4	8	5	5	20
Placings	0	0	0	0	4
Introductions	3	2	0	3	16
	—	—	—	—	—
	7	10	5	8	40

(B) Listing Proposals by Listed Companies

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Public offers	0	0	1	0	5
Rights issues	5	5	13	14	35
Private placings	*	8	17	34	70
Capital reconstructions	*	9	12	6	16
Shell reactivations	2	2	12	15	24
	—	—	—	—	—
	7	24	55	69	150

* figures not kept.

(C)

Administration of the Securities
(Stock Exchange Listing) Rules
introduced in February 1986

	<u>From 1.2.1986 to 31.12.1986</u>	<u>1987</u>
Notifiable transactions	93	182
Applications for listing	35	116
Formal objection to listing	0	1
Applications for waiver	28	32
Resumptions of trading, Suspensions and delistings	13	28
Direction of suspension	0	1
	<hr/>	<hr/>
	169*	360

* 184 annualised.

Source : Office of the Commissioner for Securities and
Commodities Trading

APPENDIX 31

PROPOSED ENTRY REQUIREMENT FOR SECOND MARKET

- (a) A market capitalisation of \$20 million to \$50 million;
- (b) Trading record of not less than two years;
- (c) Shares offered to the public at the time of admission must be newly issued shares;
- (d) Nature of business should preferably be industrial, commercial or service enterprises;
- (e) Minimum public holdings should be 15% of the total issued capital; and
- (f) Money raised should be used for the purposes of the business of the company.