Hong Kong

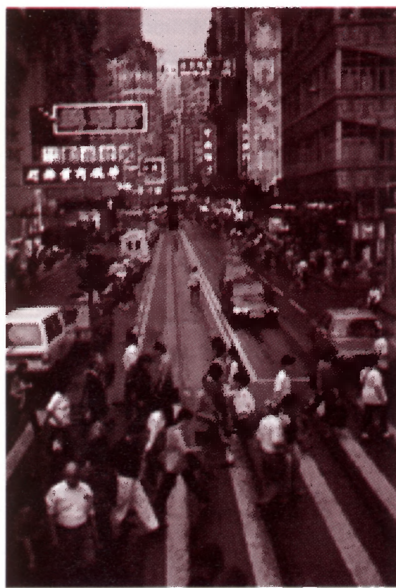
Securities regulation after the 1997 handover

by Amy N N Ang

For the better part of this century, the world engaged in an ideological duel between two contrasting economic models – the central command economy model and the market economy model. The experiment has proved that the command model cannot sustain the dynamics of an economy, as testified to by the political disintegration of the former Soviet Union and the Eastern European countries.

At this point in history, it would seem that the way forward for mankind into the next millennium will be the market economy or what may also be known as capitalism. There is a clear trend around the world to embrace with eagerness the market economy for the promise and rewards it brings.

Hong Kong, the 'Pearl of the Orient', is uniquely placed in this historic setting, being at the crossroads of both the capitalist world and the socialist-communist persuasions of her 'motherland', China (as the relationship between Hong Kong and China has most commonly been described, in the Chinese rhetorical tradition, during the handover period). After British governance of over 100 years, Hong Kong subscribes to the laissez-faire capitalist economic principle: this non-interventionist approach on the part of the government seeks to encourage enterprise in which free market competition can be given full reign.



Although Hong Kong is not a global financial centre in the same league as London, New York and Tokyo, when transferred to Chinese rule in 1997 it was the second largest international financial centre in the Asia-Pacific region, in addition to being the world's fourth largest banking centre and the sixth or seventh largest international financial centre. (At the end of 1998, the Stock Exchange of Hong Kong recorded HK$2,662 billion market capitalisation, with 680 listed companies; at the same time, there were 172 licensed banks, 60 restricted-licence banks, 101 deposit-taking companies and 141 local representative offices from over 40 countries, including 79 of the world's largest 100 banks, with total estimated external assets of over US$500 billion.) Thus, ironically, if Hong Kong continues to hold her own as an international financial centre as a part of Communist China, she will score an economic first by being an international financial centre of world standing under a socialist-communist regime. Indeed, Hong Kong's position as an international financial centre has placed such immense importance on its international role in the global economy that it is specified in the Constitution of Hong Kong, under Art. 109 of the Basic Law, that the Government of the Hong Kong Special Administrative Region shall provide:

'an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre'.

Hong Kong has a unique advantage, being bulwarked by the political principle of 'one country, two systems' conceived by the late (and prescient) Chinese premier Deng Xiaopeng. This principle is enshrined in Hong Kong's constitution under Art. 5 of the Basic Law, which states that:

'the socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years'.

Article 5 guarantees that Hong Kong, her autonomy, capitalist system, and way of life will not be interfered with by China's differing regime, albeit until 2047. It has been reported that when someone asked the late Premier as to why a period of 50 years had been chosen, he said that other financial centres in China, such as Shanghai and Shenzhen, would by then have attained sufficient maturity in their financial markets to be able to hold their own in the financial world.

HISTORICAL DEVELOPMENT OF FINANCIAL MARKETS REGULATION

Hong Kong established its first securities exchange in 1891, and this was the forerunner to the Hong Kong Stock Exchange (so-named only in 1914). In accordance with Hong Kong's colonial past, the members of the stock exchange were composed of expatriates and the British. Later, other exchanges were set up admitting the local Chinese business community, such as the Jockey Club in 1926 and Far East Stock Exchange in 1969. The futures industry, on the other hand, existed from 1910 to 1977. The Chinese Gold and Silver Exchange Society was the only futures commodity trading exchange in Hong Kong and was totally reliant on self-regulation.

The lack of any system of securities regulation meant there was no restriction on entry to the financial market. Anyone could operate a financial exchange, and nor were there any statutory requirements regulating the listing of securities. The market in its largely unregulated state lasted until the securities market crash of 1973, which caused such hardship that the Hong Kong authorities were stirred into legislative action. Although some relevant provisions of the Companies Ordinance and the Stamp Duty Ordinance existed, the first real foray into the regulation of financial markets occurred when the Companies (Amendment) Ordinance was passed in 1972 to regulate prospectuses of companies.

1973–87

In 1973, the Stock Exchange Control Ordinance was enacted, limiting the number of securities exchanges to four: the Hong

Kong Stock Exchange (1891), the Far East Stock Exchange (1969), the Kam Ngan Stock Exchange (1971) and the Kowloon Stock Exchange (1973). Similar legislative activity took place in the field of commodities futures, with the Commodity Exchange (Prohibition) Ordinance restricting the setting up and operating of commodities exchanges.

In late 1973 a global securities market crash took place, caused by a lack of effective regulation in the financial market. Some people lost their life savings as a result and there was widespread dissatisfaction against the authority. The government reacted to this financial crisis by undertaking concerted reforms which involved strengthening the financial market structure by changing the constitution and management of the exchanges in order to make them more accountable to public interests. The reforms also gave the exchanges more immediate regulatory roles in their respective markets.

The government then began to implement the Securities Ordinance in 1974. Under the ordinance, a regulatory framework for the operation of the stock exchange was set up, requiring market participants such as dealers, investment advisors and representatives to register with the Securities Commission. The Commission was also given powers to investigate breaches of any financial regulation, including insider dealing. A form of investor protection was provided by the Stock Exchange Compensation Fund, which was set up to provide compensation for clients with defaulting securities firms.

ECONOMIC FIRST

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In October 1987 a global stock market crash forced the Stock Exchange of Hong Kong to close for an unprecedented four working days. This crash once again caused massive hardship among the investors. In response, the Securities and Futures Commission Ordinance was passed, creating the new Securities and Futures Commission ('SFC') with powers of supervision, investigation, intervention, prosecution and adjudication. Through the SFC many statutes were enacted, such as the Securities (Insider Dealing) Ordinance, an improved version of the earlier Securities Ordinance of 1974. In order to prevent fraud, disclosure was made compulsory once a shareholder acquired more than 10 per cent of a company's shares. The Securities (Clearing Houses) Ordinance was enacted, thus giving the SFC control over the clearing houses through entry restriction and operational procedural stipulations which could be set out by the SFC.

In addition, the electronic Central Clearing and Settlement System (CCASS) was introduced, which improved the trading and settlement systems by providing an efficient and transparent system of pricing information.

1997 – the Asian financial crisis

On 1 July 1997 China resumed sovereignty over Hong Kong. There was much celebration to commemorate this historically significant event and a feeling of euphoria over the future of Hong Kong's continued prosperity. To many the future had never seemed brighter, but the day after the handover, before many revellers had recovered from their hangovers, the markets were rudely awoken to the sobering news of the record devaluation of the Thai baht. This financial news sent tremors across the neighbouring financial centres in the region. Thailand then made the first in a series of overtures from the troubled economies in the region to the International Monetary Fund for aid (on 28 July 1997, followed by Indonesia on 8 October and South Korea on 21 November of the same year).

This news however was followed by assurances from government officials of the newly inaugurated Government of the Special Administrative Region aimed at allaying fears or doubts about Hong Kong's financial standing. In spite of these assurances, on 15 August 1997 the Hong Kong dollar came under severe speculative attacks, causing an overnight interest rate hike of 150 points. Because of this, and the fears over high interest rates (on 23 October 1997, for example, the overnight interbank interest rate at one point rose to 280 per cent under the automatic adjustment mechanism of the currency board system), the Hong Kong stock market lost approximately a quarter of its value in the four days from 20 to 23 October. On 28 October, the securities and futures markets in Hong Kong also saw the most volatile activity in history, with the stock market registering a 1,438 points (13.7 per cent) fall in the Hang Seng Index, only to rebound the next day to 1,705 points (an 18.8 per cent rise).

All Asia stocks continued to plunge until late that year. In order to put Hong Kong's volatility in context, and to understand the gravity of the situation, it is relevant to compare developments in neighbouring economies. Prime Minister Mahathir of Malaysia imposed exchange controls and became enmeshed in a political scuffle with his deputy prime minister. President Suharto was ousted from power as the country was plunged into civil and ethnic unrest. In South Korea, households offered their gold jewellery and precious metals to aid the government's attempted 'rescue' from bankruptcy and failure. The Singapore Government urged its workforce to accept a 'national' wage reduction across the board. In Hong Kong, property prices nose-dived; there was a run on the International Bank of Asia, and disappointment at the failure of Hong Kong's own financial intermediaries in the Peregrine Group and the CA Pacific Group.

It was also in October 1997 that the Special Administrative Region Government decided to take an unprecedented step by intervening in the market and launching an offensive currency defence to the Hong Kong dollar's linked exchange rate with the US dollar. Although the government managed successfully to beat off the 'speculative rogues', it did not prevent Hong Kong's international image as a reliable financial and business centre from becoming tarnished.

The government was at pains to justify its actions to critics and the international community. This was certainly an uncharacteristic step, as it cut against the laissez-faire non-interventionist principle which Hong Kong champions, and at a practical level it diminished the foreign reserves. In hindsight, it was almost to be expected that the Hong Kong Government would act as they did. The official line was to 'safeguard the well-being of the economy and the investors' confidence in

[the] Hong Kong dollar' (Report in the *Financial Market Review*, 24 April 1998). However, from a political perspective, the Asian financial crisis really did not leave the Special Administrative Region Government much of a choice, since not only was their economy in a state of havoc, but their political mandate and credibility as the newly-inaugurated government under Chinese rule was at stake. The currency defence was born out of sheer political necessity.

THE FORCES OF CHANGE

It is apparent that the Asian financial crisis has mercilessly directed the spotlight on what have become glaring inadequacies in the financial regulatory system. In the light of this, reforms under the new administration take on a regulatory zeal and a hitherto absent urgency. But there are also other compelling forces at play, which drive the current administration to look at this more seriously.

Competition from other markets is very keen, particularly Asian emerging markets such as Taipei, Kuala Lumpur (where this was especially the case before the exchange controls imposed by Prime Minister Mahathir) and Singapore. The governments of these countries do not belong to the 'hands-off', non-interventionist school and are taking a proactive stance in managing their securities and futures industries. These energetic and ambitious neighbouring markets are eager to exploit their own domestic growth opportunities and keen to seize business throughout the recovering Asian region, which is showing signs of a recovery ('Asia's bounceback', *The Economist*, Internet Edition, 26 August 1999 Issue). It is easy to predict that the countries which will succeed are the ones which prepared themselves for the future by passing much-needed reforms to the regions' inadequate business rules and, in some countries, bringing about a fundamental change in business culture.

Those markets that are implementing reforms are making significant changes to their securities and futures industry. They are lifting restrictions on outside ownership, opening up their markets to international investors and intermediaries, investing heavily in new technology to establish cutting-edge systems for trading, settlement and clearing, enhancing their securities and futures regulatory structures to international standards, dividing their exchanges into specialist sector-specific markets, main and second boards, and expanding their product ranges to include off-shore and regional derivative instruments and debt instruments.

It is not only its neighbouring competitors that the Hong Kong financial markets must watch out for. Technological changes mean that, for example, stocks of major listed companies on the Stock Exchange of Hong Kong can be traded easily in London and also increasingly in New York. Furthermore, there are other financial instruments that are even less geographically restricted in their trading, such as financial and equity-based derivatives.

The impact of technology also challenges the traditional stock markets and market regulators since trading can now be conducted through electronic exchanges and on-line broking houses. Swept up in the tide of haste, the Stock Exchange of Hong Kong has announced that it is aiming to upgrade the operating mechanism of its trading system in 2000 to process authorised trades from the Internet and mobile phones. The Bank of International Settlements has forewarned, and rightly so, of the dangers of Internet-based trading ('Warning on Net trading', *South China Morning Post*, Business, Internet Edition, 26 August 1999). Internet trading is not as yet a fully developed area, so that when for example a system crashes, unresolved legal questions arise relating to clearing and settlement issues as to who is responsible if a trade or quotation was delayed or interrupted.

THE REFORMS

In light of the Asian financial crisis and subsequent developments in the world financial markets, the Financial Secretary, Donald Tsang, announced in his Budget Speech on 3 March 1999 an overhaul of Hong Kong's securities and futures market aimed at repositioning Hong Kong's securities and futures market for the new millennium. The reform is to be undertaken from three perspectives:

- the reorganisation of the market structure through demutualisation and merger of the exchanges and clearing houses;
- legislative reform; and
- the enhancement of the market infrastructure.

DEMUTUALISATIONS AND MERGERS

Under the process of demutualisation and merger, which has already achieved some progress, the Stock Exchange of Hong Kong ('SEHK') and the Hong Kong Futures Exchange ('HKFE'), and their three associating clearing houses – the Hong Kong Securities Clearing Company ('HKSCC'), the SEHK Options Clearing House ('SEOCH') and the HKFE Clearing Corporation ('HKCC') – will be demutualised and merged into a single holding company called the Hong Kong Exchanges and Clearing Limited ('HKEC'). The entire thrust of the reform is to integrate the securities system into a single unified whole in the form of a 'one-stop shop'. The completion of this reform will be the listing of the shares of the company on the stock exchange for trading and wider public ownership.

INTERNET TRADING ISSUES

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The members of both the futures exchange and the stock exchange have voted heavily in favour of this government reform initiative for merger and demutualisation. The next step of the demutualisation process is to make the necessary legal amendments; the Hong Kong Government is determined to implement these reforms swiftly and it has targeted the listing to be ready by September 2000. Adopting this consolidated market structure will help to streamline the fragmented market

segments and market functions of the industry, and the economies of scale in terms of market operational efficiency. Furthermore, establishing a central organisation would facilitate the development of more consistent and concerted macro-market strategies in meeting global and external challenges.

Unlike the present system, the ownership of the new company will be separated from trading rights, which will be liberalised to give unrestricted access to the exchanges. It is also intended that the shareholders of the new company – the members of the Exchanges – will have a share in the profits and dividends. The approach of the reform is to transform the new organisational market structure into that of a corporate-business driven model. This separation of ownership in terms of shares and stocks from the trading rights of the individual stockbrokers will make the stock exchange more professional by reducing conflicts of interest; there will be no exercise of vested interests by members trying to prevent outsiders from joining, as happens under the current structure. Thus, international financial players are encouraged to be stockbrokers in Hong Kong, thereby liberalising the Hong Kong system and allowing it to be even more competitive. All these reforms are also designed to prepare the system for Internet trading and 24-hour trading in the future.

LEGISLATIVE REFORM

The Asian financial crisis clearly highlighted the deficiencies of Hong Kong's financial regulation in comparison with international financial standards. However, this does not justify throwing away the entire current regulatory framework. Thus, the legislative reform consolidates and updates in a composite Securities and Futures Bill the nine ordinances currently governing the securities and futures industry.

Financial legislation must seek to strike the proper balance between giving adequate regulatory supervision to ensure, as far as possible, a fair and level-playing field with adequate protection for investors while, at the same time, being careful not to stifle entrepreneurial flair through over-regulation. Under the reforms, the expertise and experience of the SFC, which has been enforcing all the ordinances since its inception, has its supervisory and investigative authority strengthened by a clearer statement of its objectives within the financial market framework. To balance the SFC's strengthened supervisory and investigative powers, the current Securities and Futures Appeals Panel will be upgraded to a Securities and Futures Appeals Tribunal, chaired by a High Court Judge and other well-respected practitioners. It will be able to review important SFC decisions, including all licensing and disciplinary decisions and also matters relating to intermediary supervision, investment products and registration of prospectuses.

Some areas of the SFC's work will be confidential and unable to be disclosed in the usual way. As a safeguard, a Process Review Panel will be instituted to review aspects of the SFC's internal operations, such as its investigative procedures. An independent Market Misconduct Tribunal will be set up to ensure effective enforcement measures against market manipulation and abuse (e.g. through insider dealing). There will also be a flexible and cost-effective licensing regime for market intermediaries aimed at streamlining the system and improving investor protection.

More adventurous, however, is the proposal to introduce new regulation for Internet trading. Currently there is no single set of rules which can be used to control the ever-evolving range of facilities and services thrown up by automated trading systems. Therefore, the approach of the reform Bill is not to define 'market' by reference to a physical location but to provide that any unauthorised provision of a facility for bringing buyers and sellers together on a regular basis would constitute an illegal securities and futures market operation. This gives the SFC sufficient jurisdiction to take action against unsupervised financial activities wherever they may be based.

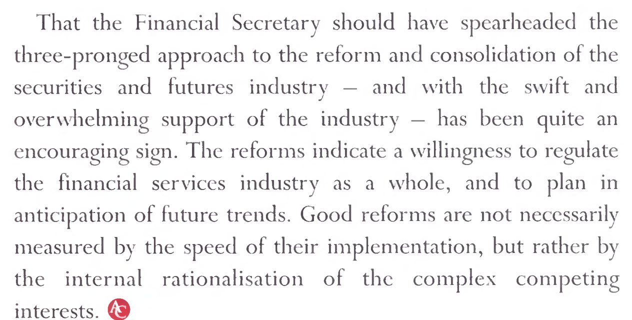
ENHANCEMENT OF MARKET INFRASTRUCTURE

The race to harness the latest and most sophisticated technology to administer the financial functions of the market is integral to the drive for reform in the financial markets. The Steering Committee on the Enhancement of the Financial Infrastructure has been set up for the specific purpose of advising on the best available systems for trading, clearing and settlement functions. Particular areas of reform include the introduction of a secure scripless securities market; it is intended to upgrade the financial systems to enable a one-stop shop facility so that there can be straight-through processing of financial transactions and a single clearing system for securities, stock options and futures transactions.

CONCLUSION

The jury is still out on the success of Hong Kong in achieving reforms to its securities and futures industry through the recent initiatives outlined above. Hong Kong is still an infant at self-governance under the Chinese political concept of 'one country, two systems'. Given her chequered financial legislation track record, which may at best be described as reactive in nature in that legislative initiatives were carried out only in response to a crisis, it is clear that the old-style British non-interventionist approach pervades and is deeply entrenched in the Hong Kong administration. Indeed, this laissez-faire policy has been widely acknowledged as being one of the key elements in Hong Kong's success. As a result, calls for regulation have never sat comfortably with the psychology of both the people and the administration of freewheeling, fast-dealing Hong Kong. It has almost been a matter of pride that there should be little or no regulation in Hong Kong.

That the Financial Secretary should have spearheaded the three-pronged approach to the reform and consolidation of the securities and futures industry – and with the swift and overwhelming support of the industry – has been quite an encouraging sign. The reforms indicate a willingness to regulate the financial services industry as a whole, and to plan in anticipation of future trends. Good reforms are not necessarily measured by the speed of their implementation, but rather by the internal rationalisation of the complex competing interests.



Amy N N Ang

Research student, Institute of Advanced Legal Studies