



Andrew L T Sheng, SBS
Chairman

Making the Markets Work Better

I have pleasure in presenting my first Annual Report of the Commission as its Chairman.

Hong Kong's securities markets last year underwent one of the most difficult and challenging years since the 1987 stock market crash. The Hang Seng Index declined by 5% from 11,519 on 1 April 1998 to 10,942 on 31 March 1999, but it touched a low of 6,544 in August 1998. During the year, there were 91 days, more than one-third of all trading days, when intra-day movement of the HSI Futures exceeded 300 points.

Total cash market turnover fell by 62% from a year ago while futures market turnover remained broadly the same. The significant reduction in stock turnover levy contributed to a 54% drop in total revenue from a year ago to \$300.6 million, causing the Commission to record its first ever deficit of \$72 million. The deficit would have been larger had it not been for our stringent expenditure control, which kept actual spending to \$373 million, 13% lower than the approved budget of \$430 million. Full details of the Commission's financial position are available in the Chief Operating Officer's Report.

THE TEST OF CRISIS

The stresses and strains of the markets in 1998-99 subjected the Commission and its dedicated staff to the test of crisis. We owe it to the former Chairman, Mr Anthony Neoh, SC, JP, under whose leadership the Commission steered through arguably the most turbulent times of the past decade and held steadfastly to its principles as I became Chairman last October.

The Asian crisis was in hindsight a global financial crisis. While flaws in domestic economic and financial structures exposed individual economies to the onslaught of the crisis, the tsunami of volatile capital flows subjected the global network of financial markets to severe stresses. These issues have led to present discussions on the international financial architecture. The Commission's active participation in these discussions, mainly through our involvement in the International Organisation of Securities Commissions (IOSCO), stemmed largely from the leadership role taken by Mr Neoh's Chairmanship of the IOSCO Technical Committee. As an international financial centre, Hong Kong needs to keep abreast of major developments in the international financial architecture and its evolving regulatory structure. Much of the reform efforts in Hong Kong's markets are to ensure that the

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The challenge of regulatory authorities in a global market is to design the regulatory and structural framework which will allow the market to function efficiently, competitively, and in a fair and level-playing field environment within a global context, ensuring at the same time that the market is not subject to highly concentrated or destabilising forces that would disrupt its functioning.

markets are competitive, efficient and in line with best practice and international standards. In short, we need to work hard to make the markets work better.

Financial markets are perhaps best understood as networks and global markets as networks of different markets linked through hubs or financial centres. Shocks in the global economy are transmitted through the networks like power surges, subjecting the markets, participants and systems to huge stresses. Those that are not designed or prepared to take such stresses are likely to trip a fuse.

That Hong Kong's financial markets and infrastructure took the stresses of the Asian crisis in stride was a testimony to their resilience. But the crisis and the need to intervene last August revealed that even in the freest of markets, there is a need to ensure that the free flow of capital does not destabilise the market itself. The ideal free market is one that everyone should be free to enter, to participate in and to leave; but no one should be free to "burn" down the market. Even the most vibrant of markets in the United States are subject to extensive regulatory oversight and constraints. While markets have become global, applicable rules and regulations remain predominantly local. Thus, the challenge of regulatory authorities in a global market is to design the regulatory and structural framework which will allow the market to function efficiently, competitively, and in a fair and level-playing field environment within a global context, ensuring at the same time that the market is not subject to highly concentrated or destabilising forces that would disrupt its functioning.

These issues were all brought to the test in 1998-99. The failure of the C.A. Pacific Securities Limited and three smaller stock brokers in early 1998 raised questions about the regulatory gap in supervision of share margin financing activities, which were not covered under either the banking or securities legislation. It also highlighted the importance of the clarity of the rules on the transfer and ownership of property rights, especially when client assets are pooled with those of unregulated intermediaries. We have acted promptly in plugging these gaps. Legislative amendment to allow for improved compensation arrangements for clients of failed intermediaries was passed last November. Moreover, the bill placing share margin financing activities under SFC regulation was introduced in the Legislative Council in March 1999.

The Commission last year also undertook a preliminary inquiry into the affairs of Peregrine Investments Holdings Limited and two of its subsidiaries, another group that collapsed amidst the Asian crisis. An independent inspector has been appointed by the Financial Secretary pursuant to an order of the Court under the Companies Ordinance to look into the matter.

TIGHTENING MARKET DISCIPLINE AND STRENGTHENING REGULATION

The financial turbulence and the speculative pressure on the Hong Kong dollar prompted a *Report on Financial Market Review*, which the Financial Services Bureau published in April last year. The Commission contributed to the review of the operating mechanisms of the securities and futures markets. I am pleased to report that most of the measures recommended have since been implemented or are in good progress.

In the wake of the market intervention last August, the Government announced a comprehensive 30-point plan to tighten market discipline and restore order to the securities and futures markets. The Commission has been working closely with the Government, the exchanges and clearing houses to put the proposals in place.

These measures were designed to strengthen regulation and enforcement on short selling, enhance risk management across the financial markets and step up enforcement on T+2 settlement rules. A large number of investigations into the settlement failures last August brought total new enforcement cases opened last year to a record 305, as against 191 new cases in the previous year. Investigations are still ongoing. The clear message is that the Commission would not hesitate to take the necessary actions to maintain the integrity of the securities and futures markets.

As part of the 30-point measures, the Commission implemented the Client Identity Rule in November with a view to ensuring that the best practice of “know your client” is followed. Close discussions were held with market practitioners about the application of the Rule.

The Commission is now taking an active role in the inter-agency Cross Market Surveillance Committee. This enables the Commission to work much more closely with other regulatory authorities to ensure that overall financial stability and integrity of Hong Kong markets are maintained. The Committee meets regularly to exchange information so that prompt and appropriate actions can be taken in response to possible cross market manipulation.

The Commission continued to engage in reforms through close consultation and discussions with the market. Last year, the Hong Kong Code on Takeovers and Mergers, a non-statutory body of general principles and rules reflecting a consensus of market opinions, underwent its first major revision since 1993, following an extensive consultation exercise. The revised Code became effective in August.

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On the Licensing side, the Commission began a major review of the licensing and registration regime last year. The results will be incorporated into the new composite Securities and Futures Bill to cover the full range of financial activities so that suitable entry requirements can be set to afford appropriate protection for investors.

As we approach the new Millennium, the Commission spent considerable energy and resources making sure that the financial intermediaries and market organisations properly deal with the Year 2000 computer issue. The Commission is prepared to take the necessary regulatory or disciplinary actions against non-compliance in order to protect the integrity of the market and interests of investors. Internally, the Commission completed its Year 2000 rectification work last December. An information technology review was also conducted and its recommendations will be implemented in stages.

REFORM IN THE FACE OF CHALLENGES AND OPPORTUNITIES

The financial crisis was both a risk and an opportunity. It gave rise to public support for the major market reform proposals announced by the Financial Secretary in his March Budget Speech. The proposals represent a comprehensive approach to address the issues faced by the securities and futures markets arising from globalisation of financial markets, advances in information technology, and increasing competition from other exchanges and alternative trading systems. These arguments for change are clear and the potential benefits of change are enormous. At the same time, if ignored, Hong Kong's competitiveness would be eroded to the detriment of all. To quote from the Government's Policy Paper on Securities and Futures Market Reform, maintaining the status quo is not an option.

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The three-pronged reform comprises the following:

- ❖ Modernising the securities legislation through the new composite Securities and Futures Bill;
- ❖ Enhancing the financial technology infrastructure of the securities and futures industry. This involved the establishment of a Steering Committee on the Enhancement of Financial Infrastructure to study a single clearing arrangement for securities, stock options and futures, and to facilitate straight through processing and scripless trading, clearing and settlement in Hong Kong; and
- ❖ Demutualisation of the stock and futures exchanges and their merger with related clearing houses, and eventually the listing of the new holding company.

These measures would bring the local securities and futures regulations in line with best international standards, update the technology infrastructure to make Hong Kong one of the most efficient, convenient and cost effective places to conduct business, and facilitate market innovation and competition.

The Commission is committed to assisting the Government in implementing the reforms. We have been encouraged by the positive responses shown by the exchanges and practitioners, and there has been no lacking in goodwill, support and comments from all parties involved.

The Commission is fully aware that reforms require consultation, broad understanding and consensus. There has been considerable airing of the issues and challenges facing the industry, market participants, the financial community, and the public at large. One of the major benefits of the reform exercise in the legislation, technology and governance area, is that market concerns and detailed questions from those most affected have been discussed in great depth and with the involvement of professional advisers and consultants.

These brought into focus the complex domestic issues, as well as considerations on the need to meet international competition and best practice standards. This consultation process has been most helpful in the final formulation of a package of reforms that will be effective, pragmatic and equitable for all concerned. Most important of all, the reform package must maintain and indeed enhance Hong Kong's competitive position as an international financial centre. We must never lose sight of the fact that the financial services sector is first and foremost a service industry for the investor. Hong Kong's competitive standing depends on both domestic and international investors finding value for money in investing through and in Hong Kong's financial markets.

GREATER TRANSPARENCY AND ACCOUNTABILITY

I would be most remiss if we advocated reforms for the market without considering the need for reforms of the Commission itself. As the Commission embarks on its second decade, it is natural to review its achievements, functions and objectives. As you may notice, a new logo adorns this Annual Report. The logo — which symbolises transparency, solidity and fairness — was unveiled by the Financial Secretary on the eve of the Tenth Anniversary of the Commission. It bears testimony to the staff's desire to deliver the best quality regulatory service and to meet the highest level of transparency and public accountability for the Commission's work, quality and standards worthy of one of the most vibrant securities markets in the world.

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The new composite Securities and Futures Bill will encapsulate most of the reforms and the philosophy underlying these reforms. This legislative overhaul is the last of the major recommendations of the Davison Report, which could not be implemented in the Commission's first decade. The Bill, which will consolidate nine separate existing ordinances, will be submitted to the Legislative Council, hopefully in the last quarter of 1999. The Bill will set out clear regulatory objectives of the Commission, which will establish the benchmarks against which the Commission's performance can be measured. By the time this Annual Report goes to print, the Commission will be consulting the market on these proposed objectives, which will include:

- ❖ Maintaining and promoting fair, efficient, transparent and orderly securities, futures and related financial markets;
- ❖ Promoting public confidence in and understanding of the financial system, and securing the appropriate degree of protection for members of the investing public;
- ❖ Minimising crime and misconduct in the securities, futures and related financial markets; and
- ❖ Reducing systemic risks in the securities, futures and related financial markets.

In the new economy driven by knowledge-based competition, the Commission is keenly aware that market development, investor education and fair regulation begin at home. Once the reform programme and the new legislation is in place, one of the highest priorities of the Commission will be strengthening its public education programme, for the investor as well as the industry.

The Commission believes that in its drive to lift the standards of the market and the protection of investors, it is important that the intermediaries are also encouraged to seek improvements.

In the area of investor education, the new Investment Resources Centre will be web-based, to take advantage of new technology. Work is already beginning to improve its content, and the Commission will work closely with the Hong Kong Securities Institute, the exchanges and clearing houses, as well as the securities community, to ensure that standards are raised in line with market innovation in products, services and risks.

STRIVING TO OFFER BETTER QUALITY SERVICE

The second prong is intermediary and staff education. The success of the Hong Kong Securities Institute in recruiting new members means that the Commission has a new and strong partner to promote higher standards of education for the securities community. The Commission believes that in its drive to lift the standards of the market and the protection of investors, it is important that the intermediaries are also encouraged to seek improvements. The Commission is

working with the Institute to offer to intermediaries and other securities personnel education programmes designed to enable them to understand and operate to the best practice standards. Within the Commission, we are also upgrading our own research capability to better disseminate and analyse new market policies, regulations, technology, products, services and trends. With the internal technology programme in place, we will continue to improve the technological and financial skills of our own staff. All these are important as the Commission is a knowledge-based institution in a knowledge-based society. Through better quality service, we believe we can help make the markets work better.

When I took office, I felt that I would be working with a committed, capable and dedicated staff at the Commission. The past year has more than demonstrated the ability, loyalty and steadfastness of the Commission staff in the face of crisis. I would like to pay tribute to the entire staff of the Commission for their hard work and dedication in a testing time. I must acknowledge the contributions of the former Chairman, Mr Anthony Neoh, SC, JP, and Executive Director, Mr David White, JP, who left the service of the Commission during the year. I would also like to welcome our new Executive Directors, Mr David Stannard and Mr Paul Bailey, the latter having been promoted from his previous position as Senior Director in recognition of his ten years of service and contributions to the Commission. Special appreciation must also be given to 26 other staff members who have been with the Commission since its establishment on 1 May 1989.

Finally, I thank the Government for its support and guidance, the Non-Executive Directors for their vision and counsel, and the market organisations, practitioners, professional bodies, academia as well as the media for their support and understanding during a most memorable year for our markets.



Andrew L T Sheng
Chairman



Anthony Neoh SC, JP
Chairman (to 30 September 1998)

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