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**Development of the Hong Kong Securities and Futures Market**

**Economy Note**

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# **Development of the Hong Kong Securities and Futures Market – Economy Note**

## **1. Introduction**

The Hong Kong securities and futures markets have been undergoing rapid changes since the Asian Financial Crisis in 1997/98. Changes are driven by globalisation of the financial industry and technology advancement as well as the problems emerging from the Crisis. This note gives a brief overview on the latest development of the market structure, securities issuance, regulatory structure, corporate governance and market infrastructure reform in Hong Kong.

Section 2 gives an overview on the changes in market structure. Section 3 describes the development with respect to securities issuance. Section 4 introduces the regulatory reform since the Crisis. Section 5 discusses the issues of corporate governance. Section 6 discusses the challenges ahead and the market infrastructure development put in place.

## **2. Market Structure**

### *Overview*

Hong Kong's securities markets are well developed, with its equity market ranking the tenth place in the world by market capitalization, and first position in Asia-ex-Japan as at January 2002. The derivatives market ranked fourth in Asia-ex-Japan as at December 2001. Table 1 provides some major indicators of the securities markets. Exchange-traded products are becoming more diversified, which include stocks, warrants, funds including exchange traded funds (ETFs) and debt securities, derivatives on stocks/indices, currency futures, interest rate futures, international stock futures and options and Exchange Fund Note futures.

### *Price Indices*

The Hang Seng Index (HSI) peaked at 16497 in 15 August 1997. It then dived with the onset of the Asian Financial Crisis. The HSI plunged to an intraday low of 6,545 points in August 1998 before the HKSAR Government intervention. Following the turnaround in the economy and the tech fever, the index climbed to a historical high of 18,302 points in March 2000. The tech bubble burst thereafter and the decline continued into 2001, concurrent with the slowdown of the global economy especially after 911 (Chart 1).

### *Market Capitalization*

As at now, the total market capitalization is US\$479.6 billion. This included 749 companies on the Main Board, with an aggregate market capitalization of US\$470.8 billion, and 89 listings on the Growth Enterprise Market, with a market capitalization

of US\$8.8 billion. After the re-balancing of MSCI World Index to account for free float, Hong Kong now takes 0.7% of the total.

In terms of market capitalization, Hong Kong is the largest market in Asia-ex-Japan and tenth largest in the world as at January 2002 (Chart 2 & 3). Hong Kong has a very high market capitalisation to GDP ratio (Chart 4), reflecting the maturity of the domestic market and its position as the regional fund raising centre i.e., listing of global enterprises such as the HSBC and PRC enterprises.

### ***Market Concentration***

Mirroring the Hong Kong economy, a substantial portion of listed companies is engaged in tertiary production, in particular, financial services, property development, technology and telecommunication. At the end of 2000, Hong Kong was the most concentrated market (based on the top 10 companies by market capitalisation) amongst developed exchanges in the world (Chart 6). The 7 largest companies accounted for 57% of the total market capitalization. 124 companies (17% of 743 listings on Main Board) had less than the minimum US\$12.8 million market capitalization required for initial listing.

Nevertheless, the concentration reduced in 2001 in the midst of price adjustment of technology and property counters.

### ***Derivatives Market<sup>1</sup>***

The derivatives market in Hong Kong is growing in both size and diversity (Chart 7). Currently Hong Kong is the fourth largest derivatives market in Asia-ex-Japan, offering eight types of derivative products<sup>2</sup> mainly on stocks and indices (Chart 8). The most actively traded derivative product is HSI Futures. In recent years, more products have been launched, and some of the more successful examples are stock options, Hong Kong Inter-bank Offer Rate (HIBOR) futures and Mini-Hang Seng Index (Mini-HSI) Futures and Three-Year Exchange Fund Note (EFN) Futures.

### ***Authorized Investment Products***

The type and number of investment products authorised by the SFC has grown substantially during the past decade. The number of authorised collective investment schemes (including unit trusts and mutual funds, investment linked assurance schemes, pooled retirement funds, etc.) increased from 1357 in 1996 to 2314 in 2001. As at February 2002, there are 98 approved fund management groups offering various retail funds in Hong Kong. With the implementation of Mandatory Provident Fund (MPF) Schemes in December 2000, 263 MPF master trust schemes and pooled investment funds were established for the purpose of MPF by end-March 2001.

## **3. Securities Issuance**

### ***Funds Raised in the Primary Market***

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<sup>1</sup> Derivatives primarily refers to futures and options listed on the exchanges.

<sup>2</sup> Including index options and futures, stock options and futures, rolling forex, HIBOR futures, EFN futures and international stock options (options on futures).

The Hong Kong stock market raised a total amount of US\$133.5 billion during 1996 – 2000, reflecting the strong demand by Mainland enterprises to raise funds through Hong Kong (Chart 9). However, fund-raising activities slowed in 2001, amidst sluggish market sentiment around the globe and fewer asset acquisitions initiated by listed companies.

For the 9 months ended 30 September 2001, there were 19 new listings on the Main Board, including 1 H-share and 2 Red Chips. Of the 16 others, 6 had initial market capitalizations of US\$25.6 million with 3 more at around US\$38.5 million. Furthermore, 6 of these companies raised exactly US\$6.4 million each (the minimum required) with 3 more at around US\$7.7 million. Similarly, 9 of the 35 new listings on GEM during the same period had fund raising size of below US\$5.1 million.

### *Number of Listed Companies*

The number of listed companies rose at a steady rate from 1990 onwards (Chart 10). Most of the listed companies on the Main Board are engaged in a wide range of service industries, while most GEM companies are much smaller and younger companies with growth potential, and are more concentrated in emerging industries.

### *eIPO System*

The electronic application for shares in initial public offerings – the eIPO system – was smoothly launch in 2000. The system enabled intermediaries to use the Internet and other means to allow investors to apply for new shares. A guideline with respect to the use of eIPO has also been published for public consultation.

## **4. Regulatory Structure**

Since the Asian Financial Crisis, the SFC has been streamlining and updating our regulatory framework to bring it in line with the international standards and best practices. The following describes the latest development.

### *30-Point Package since 1998*

In light the Asian Financial Crisis in 1997/98, the government brought in a 30-Point package tightening the regulation of the securities and futures markets. Measures in the package include the strict enforcement of the T+2 settlement process, imposing a super margin on brokers with highly concentrated positions, introducing the client identity rule, increasing the penalty for naked short selling, creating a new offence for unreported short sales, and introducing new requirements for stock lenders to keep proper records of their lending activities. In parallel, SEHK re-introduced the up-tick rule (no short selling below the current best ask price) for covered short selling and HKFE tightened the large open position reporting requirements and imposed position limits for HSI 33 Futures and Options Contracts.

The SFC is now considering relaxation of the regulations relating to short selling and derivatives activity. Relaxation measures applicable to certain market neutral transactions have been introduced. The short selling exemption is expected to enhance the liquidity of both the cash and futures markets.

### ***Regulatory Infrastructure – The Securities and Futures Ordinance***

The current securities and futures legislation is contained in 10 separate pieces of legislation. Most of which were drafted more than 30 years ago and does not cater for the developments (new systems, new products, new structures) in the markets.

The Securities and Futures Bill consolidates these 10 pieces of legislation and introduces a number of significant changes to the existing regulation of the securities and futures market in Hong Kong. It was enacted in March 2002. These changes will bring Hong Kong's regulatory standards and requirements in line with international standards.

## **5. Corporate Governance**

The SFC has focused on strengthening the corporate governance of listed companies. The reform will be in line with three key disciplines:

- Self-discipline – internal codes and controls;
- Regulatory discipline – maintaining a transparent and level playing field; and
- Market discipline – high level of transparency, accountability and competition.

Based on these three principles, the SFC has revised the rules and codes and continuously works on the disclosure requirements and accounting standards to bring our regulatory framework in line with international standards such as those in the UK and the US. The following gives an overview.

### ***Audit Committees***

During the Asian crisis, the Stock Exchange of Hong Kong (“HKEx”) strengthened its code of practice with the addition of a clause on audit committees (which listed companies were expected to form after 1 January 1999, or explain why they had not).

### ***Disclosure-based System***

In late 1999 a “buyer-beware” second board was created for fast-growing small firms, the Growth Enterprise Market (GEM), signalling a shift in Hong Kong's investor protection regime from a “merit-based system” to more “disclosure-based system”, where investors would make their own decisions based upon full, fair and timely disclosure of information. Some of the governance standards on the GEM board, such as quarterly reporting, are presently tougher than on the main board, although there are proposals to implement quarterly reporting for the main board as well.

### ***Shareholders Group***

The Shareholders Group was established in May 2001 as a mechanism to engage investors and harness their views, and provide advice and feedback to the Commission on issues relating to shareholders' rights and interests. The Group consists of 14 members drawn from different constituencies including retail and

institutional investors, professionals, academics, prominent advocates of investors' rights and the Consumer Council.

### ***Standing Committee on Company Law Reform***

In his 2000/01 Budget Speech, the Financial Secretary commissioned a comprehensive review on corporate governance in Hong Kong. The Standing Committee on Company Law Reform (SCCLR), tasked with this review, issued a Consultation Paper in July 2001. The proposals relate to various matters including connected transactions as well as the clarification of the law on shareholders' remedies and a statutory derivative action. There are also proposals on corporate reporting seeking also the views of the public on proposals to strengthen the regulatory framework for financial reporting. In the meantime, work is continuing on the second phase of the review.

### ***Listing Rules Amendments***

In January 2002, HKEx published the Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues. Among the proposals in the Consultation Paper are for –

- quarterly reporting by all listed companies including those on the Main Board;
- mandatory audit committees;
- a recommendation for remuneration committees;
- in relation to the main board, for the listing rules to provide that for connected transactions there must be voting by way of a poll, and that all resolutions will require independent shareholders' approval.

### ***Amendments to the Code on Takeovers and Mergers***

Following public consultation in April 2001, the Commission announced in October 2001 immediate reductions of the trigger threshold from 35% to 30% and the annual creeper from 5% to 2% in any 12-month period. The “trigger” is the level at which a mandatory general offer is required under the Takeovers Code. The “creeper” is the percentage by which holders of between the trigger percentage (i.e. 30%) and 50% can increase their holding without being required to make a mandatory offer. The new 2% creeper applies to shareholders with holdings of between 30% and 50%, subject to transitional provisions. Transitional provisions for shareholders with existing holdings of 30% or more but less than 35% have been put in place for the next 10 years. These changes are to bring the regulations in line with international standards.

### ***Review on listed companies***

The SFC has completed a research study that analyses the Hong Kong listing market in detail. The study benchmarks Hong Kong against other leading jurisdictions in certain key respects. Meanwhile the Commission is working on proposals to facilitate quality listings and improve the overall level of corporate governance in the Hong Kong market.

## **6. Market Infrastructure Reform**

### ***Hong Kong's Challenges***

Hong Kong is facing increasing competition and emergence of strong rivalries. New products and initiatives are emerging rapidly in other financial markets. To respond to these changes, the SFC has initiated and facilitated the following development of market infrastructure, in addition to the regulatory reform.

### ***Demutualization of Exchanges and Clearing Houses***

As part of the securities and futures market reform announced in March 1999, two exchanges and three clearing houses were merged to form the Hong Kong Exchanges and Clearing Ltd (HKEx). HKEx and its subsidiaries are profit-making companies with trading rights separated from ownership.

### ***SCEFI Project***

The Steering Committee on the Enhancement of Financial Infrastructure (SCEFI)<sup>3</sup>, formed since 1999, has expedited and overseen the implementation of FinNet<sup>4</sup> and continuously works on the feasibility of scripless securities and straight through processing to improve the cost competitiveness of the markets in Hong Kong.

### ***Market Development Initiatives***

To maintain Hong Kong's status as international financial center, the Government has recently established and chairs a Financial Market Development Task Force to oversee market development initiatives proposed in respect of the banking, securities and futures markets, debt, insurance, fund management areas. The SFC chairs the working group under this Task Force to focus on issues relating to the securities and futures markets.

### ***Cross-border Linkages***

HKEx is actively exploring opportunities to position itself in the global market architecture and expand its business scope. It is talking to overseas markets on potential alliances or linkages. It is also seeking to grow its current businesses by enhancing remote distribution (by remote access and remote membership). It will continue to introduce international products and explore opportunities for alliances, linkage and cooperative arrangements. The SFC has approved rule changes proposed by the HKEx to provide overseas clients of its Futures Exchange Participants direct access to the Automated Trading System (HKATS), the trading system of its futures market.

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<sup>3</sup> Established by the Financial Secretary in 1999, the SCEFI is to review the entire financial infrastructure, global developments in technology for securities industry and map out future development.

<sup>4</sup> This is an electronic network of Hong Kong's financial sector linking the securities and futures networks, banking and insurance network etc., in a single and unified financial infrastructure. This is provide Hong Kong with an efficient, robust, open and secure infrastructure, allowing global investors access to the full range of financial products and services through web-friendly technology.

