EMERGING FROM THE SWAMP

HONG KONG'S REBOUND: BIGGER AND BETTER

by NORMAN TARALRUD BAY

Hong Kong, its stockmarket scarred and vilified following October 1987, has again shown its talent for turning disaster into something more positive.

Given the events and economic trends since October 1987, this could be a speech about Hong Kong's infinite capacity to adapt, to shrug off the effects of violent fluctuations in business conditions and to find a way to prosper in even the most adverse circumstances.

But before affirming those views, I owe you some remarks about Hong Kong's response to the closing of the stock and futures exchange for four days in that month, the arrest of the stock exchange chairman on charges of corruption, the committee being asked to stand aside, and the takeover of management functions at both stock and futures exchanges by respected public figures – both of whom were expatriates (but more of that later).

Four or five years ago, these events might have been swept under the carpet, with the excuse that "this is Hong Kong, and everyone knows they have to look out for themselves" and the government would have muttered about "*laissez faire*" and "*caveat emptor.*" Those of you who heard the then Financial Secretary, Sir John Bremridge, address the Eighth ASAC Conference which we hosted in Hong Kong may recall his celebrated phrase: "Does Hong Kong have to choose between the excitement of being a swamp full of crocodiles or the boring hygiene of a Swedish dairy?"

At that time he concluded that something closer to the swamp than the dairy would serve Hong Kong best.

His successor, Piers Jacobs, is a lawyer and career civil servant and has different motivations, no doubt, than Sir John, who was Taipan of Swires before he took over as Financial Secretary.

Mr Jacobs had the misfortune to be telephoned in the middle of the night and asked for his blessing to close the exchange. Whether he agreed or not is less relevant than the fact that the question was asked at all.

In his predecessor's time, there were four stock exchanges, and the law of competition would probably have acted to keep one or two open, or to close all four by agreement without particular reference to the Government.

Here lies the essence of the problem, and the need for restructuring now. The Government allowed the exchanges to unite into a single body, thus removing the restraining influence of competition, but it did not put in an adequate regulatory mechanism to compensate.

However, the Government has been flexing its regulatory muscles recently in several directions. A consultative document on the "Prudential Regulation of Provident Schemes" was sent out; the populace was also being consulted on the Draft Basic Law, which is the future constitution of Hong Kong; and, of course, the Securities Review Committee's report, or the "Hay Davison

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Report" as it is commonly known, was in circulation.

For all the hullabaloo and the aggressive denunciations of these documents by interested minorities, it is unlikely that many copies have been read. Rather, it is probably true to say that the general excitement is generating more heat than light, more confusion than clear paths forward.

I am reminded of the American colonists' heated reactions to news of the Stamp Act, which in 1765 set out to impose new regulations to establish the principle of internal taxation in America both to fill the coffers of the mother country and to establish the overwhelming rights of the English parliament. As Barbara Tuchman writes in *The March of Folly:* "Hardly a family from Canada to Florida had not heard of the Act though many had little idea what it threatened. A country gentleman whose servant was afraid to go out to the barn on a dark night asked him, 'Afraid of what?' 'Of the Stamp Act,' the servant replied."

Many local stockbrokers in Hong Kong appear to share such sentiments when the Securities Review Committee Report is mentioned. On the other hand, investors, especially international users of the Hong Kong stockmarket, have given the report a quite unusually positive welcome.

But action is also beginning to emerge. The Hay Davison report was published on May 27, and the Financial Secretary has announced the acceptance of its major recommendation – the setting-up of a Securities and Futures Commission. This will be an independent statutory body outside the Civil Service, only partly dependent on government finance, and it responds to one of our recommendations, that more market expertise (with market-related salaries) must be introduced into the regulatory process, if it is to have any hope of keeping up with the rapid changes in the securities industry.

Other major recommendations of the report are:

- Change of the internal constitution of 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."

In its submission to the committee in December 1987, the Society of Security Analysts had noted:

"The most obvious anomaly at present is the exclusion of the corporate brokers with ultimate foreign parentage from standing for election to the Committee. A parallel phobia against bank-related brokers appears to be founded on the belief that local people would abandon the natural Chinese prejudice in favour of dealing with known family connections in order to deal with the lowest-cost provider of a convenient service (e.g., the local bank counter). This seems unrealistic.

"Lastly, the present system of one man, one vote, allows a large number of non-professional brokers (i.e., owners of seats whose main business is not stockbroking) to determine the operating environment for the minority who provide a full-time professional service to the public. In equity and in terms of Hong Kong's international standing, this system has obvious serious deficiencies and we recommend an activity test to determine members' eligibility to vote in elections and otherwise, or a high minimum capital requirement."

The statistics on membership show an interesting trend, reinforcing the sense of powerlessness of the major trading houses in the face of determined, but parochial, management of the exchange. Again I quote from the report:

"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

The Hong Kong Stock Exchange: once labelled a "shambles", now bouncing back as an international exchange.

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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."

The third major recommendation is for development of "a staff of professional, independent executives in the two Exchanges, with the Exchange governing bodies setting policy and the executives implementing it."

Again, our submission had commented: "These staff should be responsible to the Exchange as a whole. . . . but should be independent of the Committee itself with regard to enforcement of rules laid down by the Ordinance or directions from the Commissioner for Securities."

One of the features we have pointed out was that many existing rules were inadequately policed. You cannot have good enforcement on the cheap.

The fourth major recommendation was for extension of the stock exchange settlement period to three days (after the day of the trade), and for this to be strictly enforced, and the early development of a central clearing system. We do not quarrel with central clearing – quite the reverse, but three days is too short for the typical international settlement loop, and even the stock exchange management appears to believe that five days should be the minimum. I understand there is an international group working towards global harmonisation of settlement periods.

The fifth major recommendation concerned the futures exchange and the need to coordinate all risk management aspects in a single body. The Hay Davison committee considered recommending closure of the futures exchange, which in any case is being managed under "rescue" arrangements until October 1989, but decided that commercial viability, as determined by the board, should be the governing factor within the new proposals for the constitution of this exchange.

The committee calls for . . . an overriding requirement for companies and their auditors to show a 'true and fair view'.

Apart from these changes in institutional arrangements, which will take time to be noticeable from the outside, there are other areas of recommendation, which again follow suggestions made by our society and others, and which should have a practical and important effect if they are adopted. They include improved disclosure standards for listed companies. The committee calls for the Companies Ordinance to be changed to make it an overriding requirement for companies and their auditors to show "a true and fair view", with:

fuller profit and loss accounts;

notification of related party transactions;

disclosure of 5 per cent stakes in companies (the Government had proposed a 10 per cent threshold);

a code of dealing practice for directors;

a requirement to seek shareholder approval before major transactions, especially with related parties.

For me, the two watchwords of the report and, I hope, of the actions to follow it, are *participation* and *responsibility*. Many in Hong Kong were dismayed in January 1988 when Hay Davison told the press he was looking for a "Hong Kong solution" and hinted that it should also be a structure to see Hong Kong through to 1997, and thus be acceptable to the People's Republic of China – with all that might entail.

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But I think the report has managed to keep some of the best features of a Hong Kong solution while also bringing in a much-needed raising of standards towards international levels.

This is illustrated by the treatment of corporate finance advisory activities in the report – not one of the "major recommendations" but, in my view, potentially one of the most far-reaching.

It is no coincidence that it was in connection with a new listing that the stock exchange chairman was arrested. To quote from our submission again: "There is substantial intervention in this area by the Stock Exchange Committee, which should not be involved at all.

"For example, in the last few years the Stock Exchange Listing Committee appears to have taken the view that industrial companies in particular should have a high initial yield on first listing. As this clearly conflicts with the companies' and merchant banks' desire to obtain the maximum realisable price for the vendors (or new shares as the case may be), the result has been a high payout ratio, which in many cases has proved unsustainable in subsequent years. The effects of this pricing method have been as follows:

a) Apparent underpricing leading to heavy oversubscriptions, active 'grey market' trading, and large profits for successful stags.

b) A period of performance reflecting the company's merits *vis-a-vis* the rest of the market and accumulation by institutions to top up allocations.

c) Wholesale selling pressure once the unrealistic dividend levels are cut, followed by a period of lasting disenchantment.

"The natural volatility of industrial businesses in Hong Kong is thus compounded by an unrealistic and largely artificial pricing system for new issues which pays little regard to the difficulties of predicting future business conditions for these firms.

"The Society recommends that pricing should be left to underwriters in consultation with the company concerned, provided all statutory conditions have been met.

"The method of issuing stock should also be a matter for underwriters/advisers and the company to decide, and should not be a listing condition in itself."

This recommendation was accepted, and the report argues for the underwriters and the company to take the *responsibility* for pricing. In my view this introduces a substantial new freedom into the process and should be a major factor in encouraging international fund-raising based on the Hong Kong Stock Exchange. There are already some straws in the wind here, as shown by the recent listing of two Thai-related companies, and the reactivation of William Hunt as an international hotel company.

A further element of participation and responsibility may be introduced with the concept of a "sponsoring broker", as understood in the United Kingdom. One of the shortcomings of the Hong Kong issuing system has been the lack of continuity of broker or merchant bank with companies active in making placements and their continuing relationship with the exchange. There are numerous examples of suspensions of shares at the company's request where I feel that on proper advice the information flow and compliance with the spirit as well as the letter of the rules could be much improved.

The development of long-term underwriting relationships with brokers could also help Hong Kong develop into more of an international equity-raising centre.

In conclusion, let me return to a question I put earlier: Why *did* the Government choose to intervene this time?

Partly, I am sure, out of a sense of responsibility for having created the Unified Stock Exchange; partly, I hope, because of the representations put to Government well before the crash by bodies such as the Hong Kong Society of Security Analysts and again immediately afterwards; but significantly, too, I believe, because of the knowledge that the financial industry in Hong Kong *is* growing very fast and has the opportunity to enhance its position as a major world and regional financial centre by improving the rules and the ability of international firms to do business here.

Our own society shares this positive view and supports the strategic conclusion of the Securities Review Committee 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 market by issuers, investors and intermediaries from outside the territory."

I find it significant that an "outsider" such as Ian Hay Davison could become so imbued in six short months with Hong Kong's persistent talent for turning disaster into a platform for launching future successes, that his report not simply avoids excessive recrimination, but adopts the pragmatic Hong Kong approach of saying: OK, if we need some new rules, how can we word them so we can make the game better as well?

I mentioned earlier that there was significant expatriate involvement in the regulation of the industry in Hong Kong. This is not to say that local people will not in the end do a far better job, but I think it reflects the pattern of reaction to events in Hong Kong and to overseas developments that has characterised the evolution of regulation in Hong Kong. Because we have not before had a well-thought-out blueprint *with an international dimension*, we have not developed sufficiently localised institutions and a locally driven process. I think this will now be created and will lead to a cadre of professional administrators being attracted into this new framework. To date, Hong Kong has been too parochial in this field, and also too reliant on received UK practice. Now we should come of age and develop more effective institutions as a result.

For many investors, the Hong Kong market has been a frustrating spectator sport at times, where they have thrown their money on to the field of play and have watched it grow, certainly, but with the uneasy feeling that much of the action that was taking place was not in full view of the onlookers.

I think it was the knowledge and certainty that majority shareholders have been less than scrupulous in dealing with the public minorities that underlay the vehemence of some of the comments made about the HK markets to Burson Marsteller when they canvassed opinion after the crash. I quote from the Appendix to the Securities Review Committee Report:

"Locally and internationally, both the stockmarket 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.

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"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."

But be warned, my fellow representatives of Asian securities markets – Hong Kong *will* bounce back, and if the Hay Davison report makes it more outward-looking, then it will, like London, quickly develop into a true "International Stock Exchange" because of its natural advantages of placement and services infrastructure.

I would like to leave you with a thought from a Chinese proverb, evidently created soon after some previous Black Monday, which goes as follows: *To complete a thing, a hundred years is not sufficient; to destroy it, a day is more than enough.*

Not, I suggest, nearly enough when it comes to Hong Kong! □