

## HONG KONG'S FINANCIAL MARKETS: EVOLUTION AND OVERVIEW

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### A. Introduction

Hong Kong is in several respects an exemplary modern international financial centre, with a legal system and regulatory regime apparently supportive of the activities that it hosts. A more nuanced judgement is that its progress is recent, its legal system is in some respects challenged, and its regulatory system prone to capture.<sup>1</sup> **1.01**

Hong Kong's financial system and its position as a major centre of transnational financial activity are unique in some respects and unusual in many others. Hong Kong law relating to finance has been in some measure the most conventional aspect, although that has become subject to influences beyond transplanted English law. All important business streams typically found in sophisticated financial centres are present in Hong Kong but the composition of the territory's stock of financial assets differs from the generalized global picture illustrated in Figure 1.1 and from those of the United States, the United Kingdom, and Japan, in that its financial system is dominated by the banking sector and equity markets, the scale of each representing a high multiple of output, and general government debt is negligible. The volumes of outstanding debt securities and structured finance are modest compared with the global aggregates, even though Hong Kong's capability in these sectors is well established. **1.02**

<sup>1</sup> This theme and the one expounded from paragraph 1.35 below are taken from P Lejot, *The Place of Law: Institutional Influences on Financial Sector Agglomeration and Location Choice* (PhD dissertation, unpublished, University of Hong Kong, 2015).

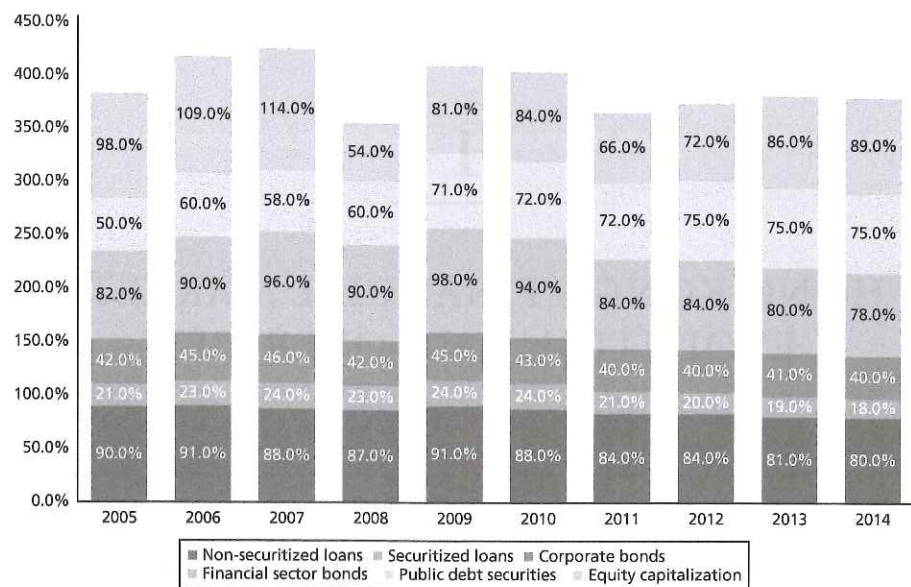


Figure 1.1 Stock of global financial assets/Global GDP

- 1.03** Financial law in Hong Kong is recent, yet partly the product of a long-standing legal transplant; it seeks to conform with international standards; it faces challenges—a lack of developed local case law, pressures against law reform, enforcement, regulation by protest, a unique quasi-constitutional provision, and an unusual context for company listings. This book's primary concern is with Hong Kong's success and its unusualness. A port of trade that became, chronologically, a place of safety for foreign vessels, a merchant city, logistical entrepôt, and after the interlude of wartime occupation, a manufacturing hub, and subsequently a commercial and financial centre. Only in the 1950s was finance first important other than in trade credit and packing loans primarily provided by trading houses, becoming a primary function from the 1970s.
- 1.04** The reception of law was similarly unusual, not only through a colonial transplant and imposed rule of law and enforcement. Regulation was light until the 1980s because it was thought unnecessary and existed for guidance in the United Kingdom barely beyond simple licensing and informal watchfulness in the Bank of England, unlike elsewhere. Colonial Hong Kong outsourced regulation to a near-monopoly commercial lender.
- 1.05** Only recently and usually after crashes, crises, and popular protests was legislation developed, some removing informal colonial institutions—such as the centrality of the Hongkong and Shanghai Banking Corporation ('Hongkong Bank') to the monetary and banking system—in favour of more conventional administrative agencies and resources, and comprehensive regulation.

Much of this volume will seek not only to examine the law relating to financial activity in Hong Kong but provide explanations for this transformation. It will in particular consider in relation to financial activity as a whole, and within each segment of Hong Kong's markets: **1.06**

- The substantive effects of article 109 of Hong Kong's quasi-constitutional Basic Law, which addresses the territory's position as a centre of international finance.
- The nature of the reception of English common law, rules of equity, statutes, and legal procedure.
- The development of Hong Kong common law and legislation law in the post-colonial period, and the juxtaposition of Hong Kong law in relation to finance with certain aspects of Chinese law.
- A long-standing relationship between recurring financial shocks in the banking and securities markets and the creation of specific regulatory or supervisory instruments, where only limited provisions existed earlier.
- The subsequent emergence since the mid-1980s of a relatively sophisticated body of regulation, under the supervision of four semi-autonomous government agencies.
- The extent of Hong Kong's conformity with internationally harmonized principles of financial regulation.
- The extent of competition among elements of the financial markets with those of other financial centres, especially where there exist differences in the regulatory policy or intensity, or where users of financial services make particular demands.

Hong Kong has been a port of trade since the mid nineteenth-century and subsequent centre of commerce but only recently developed as a major financial centre with unusual institutional foundations, the nature of which will be analysed and contrasted at intervals in this book with those of other sophisticated hubs. **1.07**

### B. Substantive and Specialist Financial Centres

Modern financial centres tend to be identified by one of three methods: **1.08**

- 'Geographical reach' refers to the dispersal of activity managed from the hub, ranging from those primarily serving the proximate area, those functioning across districts or provinces of the host state, to national-oriented centres, and those that are primarily regionally transnational or fully global in scope.<sup>2</sup>

<sup>2</sup> 'Geographical reach' appeared first in H Johnson, 'Panama as a Regional Financial Centre: A Preliminary Analysis of Development Contribution', (1976) 24 *Economic Development and Cultural Change* 2,

- 'Inter-hub connectivity' is intended to value the importance and other characteristics of hubs within the global financial system, allowing financial centres to be depicted according to network methodology as 'nodes' within a global system. Network methodology also allows banking hubs to be classified as: (i) net suppliers or users of funds vis-à-vis other hubs; (ii) by their centrality (or 'closeness' to other nodes) within the network; (iii) by their entrepôt position (or 'betweenness') and scale of intermediation in connecting other nodes; and (iv) the importance (or 'prestige') of the nodes with which they are each connected.<sup>3</sup>
- 'Functional classifications' based on dominant activities, for example, corporate credit, corporate finance, risk-based instruments, private banking, equity issuance and share trading, insurance or reinsurance, collective investment management,<sup>4</sup> or on general depictions of sources and uses of capital flows of funds, namely centres that generally export or import funds or act more evenly as financial entrepôts.

1.09 These provide frameworks for empirical studies. Most use one of four measures:

- 'Scale of banking' by assets, cross-border claims, or numbers of licensed intermediaries or headquarters offices.
- 'Financial intermediation ratios' expressing the sum of outstanding bank credit and securities market capitalization relative to national income.<sup>5</sup>

261, 'regional' being used by many cities in subsequent promotional reports. Johnson's article rehearsed work undertaken for the United States Agency for International Development (USAID), see *ibid*, 261.

<sup>3</sup> See G von Peter, 'International Banking Centres: A Network Perspective', in Committee on the Global Financial System, 'Research on Global Financial Stability: The Use of BIS International Financial Statistics', (2010) *Papers No. 40*, pp 71, 74–80; see also C Kubelec and F Sá, 'The Geographical Composition of National External Balance Sheets: 1980–2005', (2012) 8 *International Journal Central Banking* 2, 143; F Sá, 'Bilateral Financial Links', in G Caprio (ed.), *The Evidence and Impact of Financial Globalization* (Oxford: Elsevier, 2012), p 51.

Less durable network indicators include transnational telex and airline traffic, see H Reed, *The Pre-eminence of International Financial Centers* (New York, NY: Praeger, 1981), respectively now non-existent and confused by airline hub-and-spoke operations. In network analysis London's pre-1914 pre-eminence reflected 'centrality', 'betweenness', and the 'prestige' associated with the many correspondent relationships then maintained with London banks and merchants. Reed's analysis neglects bank correspondent links, see notably C Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945–1965* (London: Routledge, 2001), p 123, although those links are now arguably important chiefly in cross-border payments, operational aspects of trade finance, and in connecting with unsophisticated financial systems, all revenue-generating but insubstantive functions in terms of the approach taken here.

<sup>4</sup> See I Dufey and S Barram, 'The Impact of Offshore Financial Centers on International Financial Markets', (September/October 1997) 39 *International Executive* 5, 535, this being one of several commonly-used classifications. Risk-based instruments are chiefly 'fixed income, commodities, and currencies' (FICC), derivatives, and structured finance.

<sup>5</sup> The concept originates with R Goldsmith, *Financial Structure and Development* (New Haven, CT: Yale University Press, 1969). In its original form it is weak in the context of this study since national aggregates of total claims are not directly related to commercial origination activity; it might be more valuable to measure periodic gross additions to bank assets or securities issues, or to securities market turnover, in each case in relation to economic output.

- 'Composite indices' embracing transactional activities, organizations, and connectivity.<sup>6</sup>
- 'Connectivity between centres' commonly given by the extent of cross-border claims or organizational locations.<sup>7</sup>

The first is popular as an abnormally large banking sector in relation to local needs suggests a financial hub connecting with others beyond its own domain. No approach is perfect; each is prone to descriptive anachronisms and empirical inconsistencies, since the nature of activity in all substantive centres changes over time, and to identify features of today's finance in past eras is to risk mischaracterization. Pure offshore centres can be safely categorized by geographical reach but the designation of most centres will: (i) be arbitrary; (ii) apply centre connectivity that uses national claims as proxies for hub activity with each taken as a centre of finance; or (iii) adopt functional classifications which may neglect changing practices or over-emphasize banking activity.<sup>8</sup> Domestic-oriented hubs tend to be downplayed—claims within intermediary groups undertaken due to organizational preferences may exaggerate real activity, especially at the expense of taking account of equity issuance and trading,<sup>9</sup> for example, by failing to isolate substantive activity among financial entrepôt services, in offshore booking centres, or among those many jurisdictions operating 'international banking facilities', usually involving restricted banking licences.

Hong Kong's functional orientation has altered in a short period more often than all other important places of trade. Its pre-colonial foundations were as unplanned shelter or source of fresh water for local fishermen and ocean-going vessels, and shortly before its seizure in 1841 by a British naval expedition a place of safety for British and other foreign merchants engaged in the China coastal trade.<sup>10</sup> Declared a Crown Colony in 1843 upon the ratification of the Sino-British Treaty

<sup>6</sup> Following Reed's complex model, see above n 3, at pp 9–15.

<sup>7</sup> Connectivity suggested by office networks of commercial organizations in finance or professional services is a feature of the 'World Cities' literature.

<sup>8</sup> Not included are functions associated especially with offshore centres, e.g. payment neutrality (in structured, infrastructural, or object finance), corporate charters, rule evasion, tax avoidance, unusual corporate governance, or secrecy.

<sup>9</sup> A fault that the Bank for International Settlements (BIS) seeks to correct within the limits of the data it receives from national sources, see Bank for International Settlements, 'International Banking and Financial Market Developments', (December 2015) *BIS Quarterly Review*, referring to 'Locational Banking Statistics, Notes to Tables', 1–8, accessed 30 October 2015, <<http://www.bis.org/statistics/tablenotes.pdf>>.

<sup>10</sup> By contrast Macau became Portugal's transshipment port for Canton (Guangzhou) from the sixteenth century, with a leased settlement and rights of landing granted to Portuguese vessels, although it became a permanent enclave only in 1887, see P Van Dyke, *The Canton Trade: Life and Enterprise on the China Coast, 1700–1845* (Hong Kong: Hong Kong University Press, 2005), pp 7–10. A mid-1841 census placed Hong Kong Island's settled population at 4,350, together with a further 3,100 living 'in boats', 'in the bazaar', or being 'labourers from Kowloon', see R Sayer, *Hong Kong, 1841–62: Birth, Adolescence, and Coming of Age* (Hong Kong: Hong Kong University Press, 1980), p 203, prior to which the native population 'never exceeded 2,000 ... whether ashore or afloat', see E Eitel, *Europe in China* (Hong Kong: Kelly & Walsh, 1895), p 134.

of Nanjing, Hong Kong grew first as a port of trade, 'the guardian of the interests of Europe in China',<sup>11</sup> and from the 1850s became successively a place of transit,<sup>12</sup> a shipping hub and merchant cluster, and by the 1930s primarily an advanced trading entrepôt.<sup>13</sup> Its engagement in finance between the 1860s and 1941 was dominated by the Hongkong Bank in support of trade, to partner in projects undertaken by merchant clients, and to an occasional but continuing extent in liaising with state and other Chinese borrowers for Sterling loans placed with investors in London's foreign bond market.<sup>14</sup> Trading activity largely ceased during the Pacific War occupation, and although it grew strongly between 1946 and 1951 a post-Korean war United Nations' embargo on most trade with China led to a slump in Hong Kong's total trade and international earnings that might have constituted as much as one-third of the territory's then gross income.<sup>15</sup> That no fall occurred in total output is attributed to an industrial revolution, Hong Kong's 'spontaneous

<sup>11</sup> Ibid, p 575. The colonial territory was created in three stages in 1841–98, first by seizure and the Treaty of Nanjing in respect of Hong Kong Island; second, in 1860 by annexation of that part of the mainland forming Hong Kong harbour and the Convention of Peking in 1860; and finally a second Convention in 1898 providing a ninety-nine year lease of the remainder of the mainland south of the Shenzhen river and 230 coastal islands, see S Tsang, *A Modern History of Hong Kong* (London: I.B. Taurus, 2004), pp 38–41.

The existence of a lease rather than ceded territory provided the means by which China would come to resume full sovereignty, successive post-imperial governments having maintained that the instruments of the territory's transfer were either illegal or unenforceable while never challenging colonial rule so as to destabilize financial or general confidence in Hong Kong, especially in 1945, 1949–50, or during Hong Kong's protracted 1967 civil disturbances. Local confidence was disturbed for periods as Beijing and London discussed Hong Kong's future (see below n 68 and accompanying text), during the drafting of the Basic Law, and in particular following the violent end to the Tiananmen Square protests in 1989. Each of these events arguably encouraged many local companies to undertake precautionary changes of domicile (see below n 20 and accompanying text), notably Jardine Matheson in 1984, and the Hongkong Bank in 1991. The centrality of the bank in the territory's socio-economic life was indicated by an emotional press, see M Taylor, 'The Bank Does a Bunk: Hongkong & Shanghai to Incorporate in Britain', (27 December 1991) 150 *Far Eastern Economic Review* 52, 38, suggesting that this was 'prompted by a realisation that [the bank's] future growth was compromised by its Hong Kong base', and more seriously that the bank's chairman 'admitted that being a Hongkong-based bank jeopardised its access to international capital markets'.

<sup>12</sup> For transient Chinese emigrants as well as physical cargo, see E Sinn, *Pacific Crossing: California Gold, Chinese Migration, and the Making of Hong Kong* (Hong Kong: Hong Kong University Press, 2013), pp 90–1.

<sup>13</sup> Pre-1940s entrepôt trade provided the largest share of Hong Kong's total output, see E Szczepanik, *The Economic Growth of Hong Kong* (London: Oxford University Press, 1958), p 3, with levies on the sale of opium an important contributor to government revenues until 1941, see Tsang, above n 11, p 57.

<sup>14</sup> In most cases Hongkong Bank liaised with borrowers, formed, or joined London distribution syndicates, and in the typical contractual structure obtained at source an equitable assignment of the proceeds of customs dues and salt revenues to service and repay the issues. The first such imperial government loan of two million silver taels (£627,615) was arranged in 1874 and sold in January 1875 and March 1876, see D King, 'China's First Public Loan: The Hongkong Bank and the Chinese Imperial Government "Foochow" Loan of 1874', in F King (ed.), *Eastern Banking: Essays In the History of the Hongkong and Shanghai Banking Corporation* (London: Athlone Press, 1983), p 230. The bank arranged funding in a similar way between 1898 and 1910 for a railway joint venture with Jardine Matheson, and for larger 'reorganization loans' to assist the republican government in 1913 and 1920, see M Collis, *Wayfoong: The Hongkong and Shanghai Banking Corporation* (London: Faber & Faber, 1965), the aim of successive London managers being to 'secure ... a paramount position in the London market in respect of the finance of China, like Rothschild's in South America or Baring's in Russia', (emphasis added); *ibid*, p 157.

<sup>15</sup> See Szczepanik, above n 13, pp 45–7.

transformation' over fifteen years into a place of manufacture populated mainly by small enterprises,<sup>16</sup> greatly assisted by an influx of labour, flight capital, and entrepreneurial skills after China's 1949 revolution.

Hong Kong is unusual in these respects for three reasons:

1.12

- Its advance as a financial centre coincides with the wider recent events considered in this chapter, a progression largely unplanned, punctuated in the preceding period by bank and exchange failures, subject to occasional debilitating crises, and prompting an intensification of formal banking and securities regulation, in all representing a remarkably rapid transformation.
- In common with other prominent hubs, banks in Hong Kong generate external banking claims (whether assets and liabilities) far greater than those within the home economy,<sup>17</sup> but its financial sector is unusual in other respects, in particular, banks domiciled within the territory have a negligible share of those claims<sup>18</sup>—such banks arrange very little substantive fundraising for clients

<sup>16</sup> Ibid, p ix. Official national income data were first compiled in the mid-1960s but only published eleven years after Szczepanik's 1958 simulation; see also Tsang, above n 11, pp 162–7. Garment manufacturing was the most prominent sector, resembling agglomeration in nineteenth-century New York, which both dominated the United States reception of immigrants, and 'exploded as a manufacturing town as industries such as sugar, publishing, and most importantly the garment trade clustered around the port', see E Glaeser, 'Urban Colossus: Why is New York America's Largest City?', in E Groshen (ed.), *Urban Dynamics in New York City*, (Federal Reserve Bank of New York: Economic Policy Review, December 2005, Vol. 11, No. 2, 2005), pp 7, 10. Beginning around 1860, SME garment manufacturers accounted for New York's largest share of employment until 1967, and of output until the early 1920s, *ibid*, pp 15–19, when it began to be overtaken by information-driven activities such as finance, *ibid*, pp 19–22.

<sup>17</sup> For example, BIS September 2014 data show Hong Kong as the eighth largest among forty-four reporting states and territories by both cross-border assets and liabilities. As with other offshore centres a higher than average share of such assets are due from banks overseas (70.4 per cent of assets compared to the simple average of 58.7 per cent) but a lower than average share of liabilities (61.5 per cent compared to 68.4 per cent), see BIS locational banking statistics Tables 2A–D and 3A and B, accessed 30 October 2015, <<http://www.bis.org/statistics/bankstats.htm?m=6%7C31%7C69>>, and author calculations. Hong Kong's rankings by external claims have been broadly consistent since it first provided data to the BIS in 2003, when its end-period share of total assets was 3.2 per cent (4.2 per cent in September 2014). That share rose to 9.0 per cent in 1995 before gradually declining.

<sup>18</sup> Hong Kong domiciled banks accounted for a far smaller proportion of external claims of any recognized centre of finance, with the exceptions of Luxembourg and Cayman Islands, see BIS locational banking statistics Table 8A, accessed 30 October 2015, <<http://www.bis.org/statistics/bankstats.htm?m=6%7C31%7C69>>, and author calculations. None of the four banks most entrenched in domestic activity is now under local ultimate control (two subsidiaries of HSBC Holdings, a forerunner having acquired its largest local competitor, Hang Seng Bank, during a 1965 liquidity crisis; one apiece of Bank of China and Standard Chartered) although each has a Hong Kong listing, and Hongkong Bank's operations are typically identified as local and its Hong Kong share register is thought to be substantial. The Hongkong Bank was founded and managed locally (except in 1941–6), albeit with guidance from an influential consultative committee in London for much of the pre-1941 period. It transitioned to a near-conventional group corporate structure located in Hong Kong from 1962 (see F King, *The Hongkong Bank in the Period of Development and Nationalism, 1941–84: From Regional Bank to Multinational Group* (Cambridge: Cambridge University Press, 1991), pp 578–92), was reconstituted under a United Kingdom holding company in 1991, and moved its group domicile to London in 1993. The group's Hong Kong and other Asia Pacific 2013 operating profits were respectively 39.6 per cent and 69.1 per cent of the total, while accounting respectively for 20.8 per cent and 33.4 per cent of total assets, and only 18.1 per cent and 31.8 per cent respectively of all customers loans, see HSBC Holdings plc, 'Annual Report and Accounts 2013, Segmental analysis', (2013), 472–8.

through securities issuance or syndicated loans,<sup>19</sup> and a majority of stock exchange listings and those of the most well-capitalized companies are domiciled elsewhere.<sup>20</sup> Hong Kong's substantive financial activity may be characterized as predominantly that of an entrepôt as it was when physical trade was the city's preoccupation, that is, host and provider of human capital and other professional resources to financial transactions arranged by non-local banks and advisers, most of which involve other non-local counterparties.<sup>21</sup>

- Hong Kong law (especially but not wholly) in respect of financial or commercial matters is an unusual product of an effective, comparatively simple transplant of English law and procedure with recently enacted regulation. It is also characterized by a strong modern policy inclination towards meeting international regulatory norms, a relative lack of locally originated case law, a unique quasi-constitutional provision as to the territory being sustained as an international centre of finance, a similarly given exclusion of the application in Hong Kong of the law of China as the sovereign jurisdiction, and in certain fields potential conflicts between established international custom and Hong Kong common law with that distinct supervening jurisdiction.

- 1.13 The next section considers these characteristics together with other factors typical of modern hubs.

### C. A Recent Centre of Finance

- 1.14 General and segmental rankings published in the last decade place Hong Kong among the most prominent international financial hubs,<sup>22</sup> as Tables 1.1, 1.2,

<sup>19</sup> See *International Financing Review*, league table data 2000–14, accessed 18 September 2015, <<http://www.ifre.com/data/table-data/>>. The contention relies on the market shares of the leading ten new and secondary issue bookrunners of Asian (excluding Japan) debt and equity securities being dominated by Organisation for Economic Co-operation and Development (OECD)-domiciled firms. This is not unique: non-retail financial activity in New Zealand is overwhelmingly foreign-controlled, but is unusual among important and substantive hubs.

In this context, 'arrange' refers to transaction instigation and execution signified by the term 'bookrunner', rather than any hierarchical honorifics used for publicity reasons to distinguish transaction participants with differing risk commitments, a device explained by banks' demand for reputational capital, see Q Liu, P Lejot, and D Arner, *Finance in Asia: Institutions, Regulation and Policy* (Abingdon: Routledge, 2013), p 242.

<sup>20</sup> See D Donald, *A Financial Centre for Two Empires: Hong Kong's Corporate, Securities and Tax Laws in its Transition from Britain to China* (Cambridge: Cambridge University Press, 2014), pp 57–8, and suggesting that corporate and securities legislation and cross-border mutual recognition among securities regulators now largely facilitate Hong Kong's provisions in respect of disclosure and other resulting investor protection needs, *ibid*, pp 153–6.

<sup>21</sup> This applies to a lesser extent to domestic commercial banking involving local clients.

<sup>22</sup> See in particular the Global Financial Centres Index, summarized for 2007 and 2013–14 in Table 1.1, a semi-annual ranking combining indices from many sources and self-selected polling, begun in 2007

and 1.3 show. Its 2013 share of world trade exceeded those of all but seven World Trade Organization (WTO) members, all sovereign states far larger in population; it was sixth by the value of exports of commercial services,<sup>23</sup> and fifth (behind the European Union, United States, Singapore, and Switzerland; well ahead of Japan) by the value of financial sector exports.<sup>24</sup> Aggregate financial activity in several segments has matched or exceeded all other centres at intervals since 2006,<sup>25</sup> but while Hong Kong is well ranked in managed assets, debt securities, foreign exchange, and derivative products it is far adrift by volumes of activity after New York, London, and Tokyo, each of which is endowed with substantial domestic or entrenched transnational demand—Hong Kong's engagement in managing transactional activity for mainland China clients is evidently privileged but less readily controlled. The territory has been classed consistently highly in the World Bank's annual ease of 'Doing Business' surveys,<sup>26</sup> and in more subjective measures of the rule of law expressed as 'commercial freedom',<sup>27</sup> while the International Monetary Fund's (IMF) most recent systemic assessment concludes that the financial system is one of the world's largest, most developed, and sufficiently well regulated so as 'to withstand a diversity of shocks'.<sup>28</sup> Tables 1.1, 1.2, and 1.3, reproduce two well-known rankings, one commercial and one academic.

by Z/Yen, a consultancy sponsored in this project by agencies in London and Qatar, accessed 30 October 2015, <<http://www.zyen.com/research/gfci.html>>; and the World Cities rankings published since 2000 by the Globalization and World Cities Research Network at the University of Loughborough, summarized in Table 1.3, accessed 30 October 2015, <<http://www.lboro.ac.uk/gawc/world2012.html>>, the latter classifying centre connectivity suggested by the location choices of transnational finance and other service sector organizations. The former ranked Hong Kong third of eighty-three centres as at September 2014 and the latter placed Hong Kong first in a second tier of eight cities, the first tier comprising London and New York, in a total of 314 centres of many kinds. The second tier is described as 'highly integrated cities that complement London and New York', *ibid*. See also the World Economic Forum Financial Development Index, accessed 30 October 2015, <<http://www.weforum.org/reports/financial-development-report-2012>>, last published in 2012 based on member polling for sixty-two economies, placing Hong Kong first overall and for banking services, second after Singapore for 'business environment', and within the top ten for five other composite categories.

<sup>23</sup> See WTO, *International Trade Statistics* (28 October 2014), Table I.7 and I.10, accessed 30 October 2015, <[http://www.wto.org/english/res\\_e/statis\\_e/its2014\\_e/its14\\_toc\\_e.htm](http://www.wto.org/english/res_e/statis_e/its2014_e/its14_toc_e.htm)>.

<sup>24</sup> *Ibid*, Table III.17.

<sup>25</sup> E.g. in proceeds raised in new listings and in the market capitalization of its stock exchange owning company (HKEC), see Liu, Lejot, and Arner, above n 19, s 9.3, and in respect of external banking claims, see above n 18.

<sup>26</sup> Accessed 30 October 2015, <<http://www.doingbusiness.org/reports/global-reports/doing-business-2015>>.

<sup>27</sup> The most well-reported may be the Heritage Foundation's Index of Economic Freedom—accessed 30 October 2015, <<http://www.heritage.org/index/ranking>>—which assigns rankings according to subjective and objective assessments of the rule of law (measured by property rights and freedom from corruption), size of government ('fiscal freedom' and scale of government spending), regulatory efficiency (business, employment, and monetary 'freedoms'), and market openness (trade, investment, and financial 'freedom'), see, accessed 30 October 2015, <<http://www.heritage.org/index/book/methodology>>.

<sup>28</sup> See IMF, 'People's Republic of China—Hong Kong Special Administrative Region', (May 2014) *Financial System Stability Assessment, IMF Country Report No. 14/130*, 6–7.

SECURITIES REGULATION:  
THE SECURITIES AND FUTURES  
COMMISSION AND HONG KONG  
EXCHANGES AND CLEARING LIMITED

<b>A. Regulatory Framework</b>	4.01	(7) Type 7: Providing automated trading services	4.132
(1) Evolution	4.01	(8) Type 8: Securities margin financing	4.134
(2) Three-tier system: Government, SFC, and HKEx	4.12	(9) Type 9: Asset management	4.135
(3) Committees, tribunals, and panels	4.38	(10) Type 10: Providing credit rating services	4.136
(4) Interaction with local regulators	4.41	(11) Type 11: Dealing or advising in OTC derivatives	4.137
(5) International regulatory cooperation	4.47	(12) Type 12: OTC derivative client clearing services	4.138
(6) SFO, subsidiary legislation, and regulations	4.50	(13) Securities activities of banks	4.139
(7) HKEx Listing Rules	4.58		
<b>B. Licensing and Registration</b>	4.63	<b>D. On-going Requirements and Compliance</b>	4.140
(1) Licensing of corporations	4.77	(1) Securities activities of banks	4.146
(2) Temporary licences	4.82	(2) Securities firms	4.154
(3) Fitness and properness: Corporations and AFIs	4.84	(3) Client assets and record keeping	4.160
(4) Associated entities	4.98	(4) Conduct of business	4.163
(5) Licensing of representatives	4.102	(5) Discipline	4.166
(6) Fit and proper guidelines for individuals	4.105	(6) Securities market infrastructure providers	4.168
(7) Securities market infrastructure providers	4.108	<b>E. Conduct of Business</b>	4.175
<b>C. Regulated Activities</b>	4.113	(1) Code of Conduct	4.176
(1) Type 1: Dealing in securities	4.117	(2) Internal Control Guidelines	4.208
(2) Type 2: Dealing in futures	4.119	<b>F. Compensation, Insurance, Resolution, and Insolvency</b>	4.221
(3) Type 3: Leveraged foreign exchange trading	4.121	(1) Investor Compensation Fund	4.222
(4) Type 4: Advising on securities	4.126	(2) Insurance cover	4.232
(5) Type 5: Advising on futures contracts	4.128	(3) Resolution regime	4.237
(6) Type 6: Advising on corporate finance	4.130	(4) Insolvency	4.240
		<b>G. Conclusion</b>	4.243

## A. Regulatory Framework

## (1) Evolution

- 4.01** The first stock exchange in Hong Kong was formed in 1891. By 1973 the exchanges had increased in number to five, including the Hong Kong Futures Exchange Limited ('HKFE'), and were virtually unregulated. The market was planning to open several more exchanges at around that time. This was of great concern to the authorities because of the lack of regulatory control over the exchanges' activities. The first regulatory response was the enactment of the Stock Exchange Control Ordinance in February 1973, which forbade the opening of further exchanges.
- 4.02** The next major event was the market crash of March 1973. This led to the enactment of the Securities Ordinance and the Protection of Investors Ordinance, on advice from the Companies Law Revision Committee. The Securities Ordinance created a regulatory framework which included the establishment of a securities commission (i.e. a government body) and a commissioner for securities.
- 4.03** Prior to 1987 capital market regulation in Hong Kong was minimal. The various exchanges operated largely on the basis of self-regulation in accordance with the common law. While a securities commission, a commodities trading commission, and a stock exchange compensation fund had been established and numerous ordinances enacted, to address securities regulation during the 1970s,<sup>1</sup> the failure of the market in October 1987 exposed the inadequacies of the then regulatory framework.<sup>2</sup> In November 1987, as a result of the crisis, the government commissioned the Securities Review Committee to develop a plan to upgrade Hong Kong's securities market infrastructure to international standards.
- 4.04** A more serious market crash in October 1987 triggered a further review of the regulatory framework: a Securities Review Committee under Ian Hay Davison was appointed to review the financial markets and report its findings. Most of the Securities Review Committee's recommendations (the 'Hay Davison Report') were adopted. The report served as a blueprint for the modernization of capital market regulation in Hong Kong throughout the late 1980s and 1990s.<sup>3</sup>

<sup>1</sup> E.g. Securities Ordinance (Cap. 333); Protection of Investors Ordinance (Cap. 335); Stock Exchange Unification Ordinance (Cap. 361).

<sup>2</sup> See Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities Industry: Report of the Securities Review Committee* (Hong Kong: Government Printer, 1988) ('Hay Davison Report').

<sup>3</sup> *Ibid.* The Hong Kong administration's brief to the committee to examine the functioning of the equity and futures markets began, '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 ...' (emphasis added), see Hay Davison Report, above n 2, para 2.1, a phrase taken from the language that was to become article 109 of the Basic Law, see ch 1 ss 1.38-9.

Hong Kong made a sustained effort to develop its securities markets' legal, regulatory, and operational infrastructure following the world-wide market collapse of 1987.<sup>4</sup> Efforts in this direction prior to 1997 included the creation of the Securities and Futures Commission ('SFC') and the demutualization and merger of the Stock Exchange of Hong Kong Limited ('SEHK'), HKFE, and related clearing houses to form the Hong Kong Exchanges and Clearing Limited (HKEx). This helped enable Hong Kong's equity markets to become the second largest in Asia by turnover and market capitalization after Japan's, and at intervals in the last decade the world's leading IPO hub.

The main points in the Hay Davison Report stated the need for:

- systemic stability;
- an orderly and smooth-functioning market, which is fair and free from manipulation and deception;
- adequate investor protection;
- practitioner-based regulation—that is, operated by professionals with an industry or regulatory background;
- checks and balances with the exchanges being supervised by a commission that was independent of the government, with the government only to intervene if and when the commission failed to regulate properly; and
- market participants to be represented on exchanges and clearing houses.

The structure recommended and implemented under the Hay Davison Report has operated since 1989 and remains basically unchanged.

Hong Kong's securities industry and regulatory framework developed rapidly after the Hay Davidson Report reforms were implemented.<sup>5</sup> Reforms undertaken included: (i) significant strengthening of the market-driven monetary and fiscal environment, in particular changes to the Exchanges' constitutions to improve frontline regulators and make them more accountable by acting in the public interest; (ii) improve market technology infrastructure in respect of both trading and settlement systems, including the introduction of the electronic Central Clearing and Settlement System (CCASS) and the Derivatives Clearing and Settlement System (DCASS); (iii) the establishment of the SFC as the market-wide regulator; and (iv) initiating international regulatory standards conducive to market transparency and fairness.

In April 1996, the SFC published a consultation response that recommended consolidating and rationalizing numerous existing ordinances into a composite Securities and Futures Bill, which was subsequently enacted in similar form to the

<sup>4</sup> See K Wong, 'The Hong Kong Stock Market', in R Ho, R Scott, and K Wong (eds.), *The Hong Kong Financial System: A New Age* (Hong Kong: Oxford University Press, 2004, 2nd edn), p 215.

<sup>5</sup> Government of the Hong Kong Special Administrative Region, 'A Policy Paper on Securities and Futures Market Reform', (March 1999), 6.

current Securities and Futures Ordinance (SFO). The SFO is largely a consolidation of ten ordinances, which regulates the securities, futures, and leveraged foreign exchange industries, discussed in Section A(6).

- 4.10** Significantly, from 1996 to 2006 the Hong Kong securities and futures market went through a profound transformation from a largely domestic market to an international market with active trading both in equity and derivative products.
- 4.11** Each stage of market transformation has led to more lucid regulatory objective statements and the establishment of professional regulatory bodies designed to carry out these objectives. Nevertheless, Hong Kong has generally aimed to minimize regulation to a level commensurate with the existing state of knowledge.

(2) **Three-tier system: Government, SFC, and HKEx**

- 4.12** Hong Kong's securities regulatory system has three tiers: the government, the SFC, and HKEx.

*Hong Kong Government*

- 4.13** The government is not involved in the day-to-day regulation of the securities industry. However, the Financial Services and the Treasury Bureau (FSTB) facilitates and coordinates initiatives to upgrade the overall quality in Hong Kong's financial sector. Its goal is to guarantee that Hong Kong's regulatory regime is up to date and meets the needs of investors. There is a constant dialogue between the government and the SFC about the state of regulation and the industry itself.

*Chief Executive*

- 4.14** The Chief Executive of the Hong Kong Special Administrative Region (SAR) appoints the Chairman, Deputy Chairman (optional), and the Chief Executive Officer (CEO) and directors (both executive and non-executive) of the SFC, and may remove any member of the SFC and also determines their terms and conditions of office.<sup>6</sup> The Chief Executive of the Hong Kong SAR may give written directions to the SFC regarding how it should seek to meet its objectives and how it should perform its functions.<sup>7</sup> Further, the SFC must submit estimates of its income and expenditure for the coming financial year to the Chief Executive for approval, with the Financial Secretary tabling the estimates with the Legislative Council.

*Financial Secretary*

- 4.15** The Financial Secretary is one of the principal officials in the government, together with the Chief Secretary, the Secretary for Justice, and twelve bureau directors. The

<sup>6</sup> SFO sch 2.

<sup>7</sup> SFO s 11.

primary duty of the Financial Secretary is to oversee policy formulation and implementation in financial, monetary, economic, and employment matters.

The Financial Secretary has had effective overall authority over the SFC both before and after the implementation of the ministerial system of accountability on 1 July 2002. The Financial Secretary may demand that the SFC supply information on those principles, practices, and applicable policies that it determines will meet its objectives and allow it to perform its functions. The SFO states that the SFC may provide advice and information to the Financial Secretary on matters relating to the securities and futures industry. The SFC prepares both an annual report and financial statements, which are submitted to the Financial Secretary who in turn tables them with the Legislative Council. In relation to companies, the Financial Secretary may appoint inspectors and investigators, if there is a need in problem situations.

*SFC*

Under the Hong Kong's ministerial system, the SFC has the closest regular contact in government with the Secretary for Financial Services and the Treasury, and the Permanent Secretary for Financial Services and the Treasury (Financial Services), who heads the Financial Services Branch of the FSTB and reports to the Secretary.

The SFC was established on 1 May 1989 under the Securities and Futures Commission Ordinance<sup>8</sup> (now consolidated into the SFO), pursuant to a recommendation by the Securities Review Committee. It is a statutory body responsible for regulating the securities and futures markets in the interests of investors through administration of the laws relating to the trading of securities, futures, and foreign exchange contracts within Hong Kong.

The SFC is an independent non-governmental statutory body outside the civil service. The directors of the SFC include the Chairman, the CEO, and at least six other directors. The majority of SFC directors must be non-executive directors who are prominent persons from the industry or the legal and accountancy professions, or other leaders in the securities and futures industry. The SFC may in addition employ such staff as it considers appropriate. Each of the four executive directors other than the CEO supervises an operational division. The operational divisions are: (i) Corporate Finance; (ii) Enforcement; (iii) Investment Products; and (iv) Supervision of Markets. There is also a separate Corporate Affairs Division, a Legal Services Division, along with Licensing and Intermediaries Supervision Departments. These divisions and departments are supported by various committees responsible for different aspects of the SFC's internal corporate governance, including among others, audit, remuneration, and budget, all of which have independent members to provide advice.

<sup>8</sup> Cap. 24 (now repealed).



**4.20** The SFC has a statutory duty to ensure the enforcement of relevant provisions of the related ordinances, for example the SFO and the Company (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32).

**4.21** The six regulatory objectives of the SFC, as stated in section 4 of the SFO, are to:

- maintain and promote the fairness, efficiency, competitiveness, transparency, and orderliness of the securities and futures industry;
- promote understanding by the public of financial services including the operation and functioning of the securities and futures industry;
- provide protection for members of the public investing or holding financial products;
- minimize crime and misconduct in the securities and futures industry;
- reduce systemic risks in the securities and futures industry; and
- assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

**4.22** Regulatory functions of the SFC cover five major areas: (i) market infrastructure and trading; (ii) financial intermediaries; (iii) investment products; (iv) listings and takeovers; and (v) enforcement.<sup>9</sup> The statutory functions and powers of the SFC are wide and are set out in section 5 of the SFO. So far as reasonably practicable, the SFC's principal market functions are to:

- take such steps as it considers appropriate to maintain and promote fairness, efficiency, competitiveness, transparency, and orderliness of the securities and futures industry;
- supervise, monitor, and regulate the activities of: (i) recognized exchange, clearing houses, recognized exchange controllers or recognized investor compensation companies, or persons carrying on regulated activities by the SFC other than registered institutions; and (ii) registered institutions that are regulated or required to be regulated by the SFC under any relevant provisions;
- promote and develop an appropriate degree of self-regulation in the securities and futures industry;
- promote, encourage, and enforce the proper conduct, competence, and integrity of persons carrying on regulated activities;
- take steps to ensure that relevant provisions are complied with;
- maintain and promote confidence in the securities and futures industry in a manner that is appropriate, including exercising discretion to make public disclosures on matters incidental to performing its functions;
- cooperate with and provide assistance to other regulators in Hong Kong and elsewhere;

<sup>9</sup> See, SFC, 'Regulatory Functions', (September 2012), accessed on 8 November 2015, <<http://www.sfc.hk/web/EN/regulatory-functions>>.

- promote, encourage, and enforce internal control and risk management systems by persons carrying on regulated activities, including registered institutions in the case of any regulated activities they conduct;
- suppress illegal, dishonourable, and improper practices in the securities and futures industry;
- take appropriate steps required by the Financial Secretary for the purpose of assisting in maintaining the financial stability of Hong Kong;
- recommend reforms to law relating to the securities and futures industry;
- advise and provide appropriate information to the Financial Secretary; and
- perform functions imposed by the SFO or any other ordinance.

Other functions relate to investor protection and include promoting: investor education; the provision of sound, balanced, and informed advice regarding transactions or activities related to financial products; investors' understanding of the securities and futures industry, and the benefits, risks, and liabilities associated with investment products; investors' understanding of the importance of making informed investment decisions and taking responsibility for those decisions; investors' appreciation of the benefits of purchasing different types of financial services including investing in financial products through regulated persons; and to secure an appropriate degree of protection for members of the public investing or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products.<sup>10</sup>

In addition, the SFC has general duties as stated in section 6 of the SFO to: (i) help maintain the status of Hong Kong's position as an competitive international financial centre; (ii) facilitate innovation in financial products; (iii) avoid restrictions on competition; (iv) act in a transparent manner; and (v) use its resources efficiently.

The SFO provides that it may not delegate certain functions of the SFC to others. These are detailed in schedule 2, part 2 of the SFO and include powers *inter alia* to: make subsidiary legislation; establish committees under section 8 of the SFO; suspend exchange companies; appoint external investigators; and investigate in the business operations of licensed corporations.

The SFC, as the oversight regulator, is primarily responsible for detecting market malpractices with statutory implications, and would include: (i) scrutinizing market activities to detect potential breaches of laws relating to the securities and futures market; (ii) conducting investigations of possible statutory offences that fall within its jurisdiction, including those commenced on referral from HKEx, other agencies, and complaints from the public; and (iii) overseeing the surveillance actions undertaken by HKEx and performing cross-market surveillance of activities between HKEx markets and non-HKEx markets.

<sup>10</sup> SFO s 4.

*HKEx*

**4.27** The securities market and derivative market, and related clearing houses in Hong Kong are operated by HKEx, a listed company on the SEHK. It is the frontline regulator of listed companies in Hong Kong. HKEx regulates listed issuers, administers listing, trading, and clearing rules, and provides services to participants and users (i.e. Issuers and intermediaries) of its exchange and clearing houses. Its services comprise trading, clearing and settlement, deposit and nominee services, and information services.<sup>11</sup> HKEx is at the core of one of Asia's few truly international financial centres. Further, it is ideally positioned to support the mainland's immense capital and financial technology needs and possesses all the natural ingredients to become the leading 'full service' Asian market as well as the Asian pillar of the global securities and futures trading markets.<sup>12</sup> Under the government's strategy, HKEx is to strive for certain medium-term aspirations, namely: (i) to be the Asian-time-zone pillar of the global futures and derivatives markets and one of the top five equities markets in the world, with a focus on mainland opportunities and customers; and (ii) the Asian centre of excellence for exchange-related technology, regulation, and services, with a focus on becoming the preferred Asian partner for other major equities and derivatives exchanges seeking to build global alliances.<sup>13</sup>

**4.28** The board of HKEx is a mix of directors appointed by the government (the majority) and those elected by the shareholders; the board elects the Chairman and appoints the Chief Executive. The Chairman of HKEx must be approved by the Chief Executive of the Hong Kong SAR, while the Chief Executive of HKEx has to be approved by the SFC.

*HKEx and SFC supervision*

**4.29** The SFC supervises and monitors the activities of HKEx, the exchange companies and the clearing houses, approves their rules and amendments to the rules, approves fees charged by them, and administers and enforces the relevant applicable legislation. It also carries out regular reviews of these activities.

**4.30** Except in relation to the management of business risk, and the enforcement of their own listing, trading, clearing, and settlement rules, HKEx, the exchanges, and the clearing houses are not responsible for frontline prudential and conduct regulation of market participants, which are performed by the SFC.

<sup>11</sup> See, HKEx, 'Company Profile', accessed on 8 November 2015, <<https://www.hkex.com.hk/eng/exchange/corpinfo/profile.htm>>.

<sup>12</sup> Hong Kong SAR Government, 'Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre', (July 1999).

<sup>13</sup> Hong Kong SAR Government, above n 12, 5-6.

*HKEx, the exchanges, and clearing houses*

On 6 March 2000, the SEHK, HKFE and the three associated clearing houses, Hong Kong Securities Clearing Company Limited (HKSCC), the SEHK Options Clearing House Limited (SEOCH), and HKFE Clearing Corporation Limited (HKCC), became wholly owned subsidiaries of HKEx (collectively 'HKEx Group'). HKEx is an exchange controller recognized by the SFC under section 59 of the SFO. The SEHK and HKFE are recognized under section 19 of the SFO as exchange companies that may operate a stock market and a futures market, respectively, in Hong Kong. The three clearing houses obtain their recognition under section 37 of the SFO. A recognized exchange controller may control a recognized exchange company or clearing house. HKEx is responsible for ensuring an orderly and fair market in securities and futures contracts traded on or through the SEHK and HKFE respectively. HKEx is required to ensure that risks are managed prudently, to act in the interests of the public, having particular regard to the interests of the investing public, and to ensure that where such interests conflict with any other interests, the former should prevail. The SEHK is also responsible for administering the Listing Rules. **4.31**

*HKEx regulation*

The HKEx retains self-regulatory responsibilities as a cornerstone of its business. Priority is placed on reinforcing HKEx's 'badge of quality'.<sup>14</sup> All regulatory functions are housed in a single unit, separate from the exchanges and clearing houses, to provide organizational independence. This central regulatory unit is responsible for HKEx listing and listed company related rules (subject to SFC approval and review). HKEx's regulatory functions are reported directly to its CEO and are structured into four divisions: listings (including issuer compliance), admissions (including user compliance), surveillance, and enforcement. **4.32**

In relation to listing and corporate finance matters, HKEx remains the frontline regulatory organization with increasing statutory support from the SFC. The Listing Division is an organizational unit of the HKEx qua corporate group. The Listing Committee is a sub-committee of the Board of the SEHK, itself a subsidiary of HKEx. The Committee's composition is specified in the Listing Rules<sup>15</sup> as being twenty-five persons comprised of exchange participants, representatives from listed companies and market practitioners and users, and the CEO of HKEx (or the Chief Executive of HKEx as an alternate). **4.33**

The powers as exercised by the Listing Division are subject to review by the Listing Committee, and the powers of both the Listing Division and Listing Committee are subject to an appeal and review process by the Listing Appeals Committee. This is discussed further in Chapter 6. **4.34**

<sup>14</sup> Hong Kong SAR Government, above n 12, 13.

<sup>15</sup> LR 2A 17.

- 4.35** In relation to market surveillance, HKEx focuses on trading operations and risk management, including: (i) enforcement of trading and clearing rules and detection of trading malpractices by users (liaising with the SFC as necessary in relation to those which may involve statutory offences); (ii) maintenance of market transparency by monitoring price and turnover movements on a real time basis and requiring prompt disclosure of price sensitive information; (iii) assisting in the risk management process by monitoring exceptional concentrations in positions and unusual price fluctuation; (iv) interaction with market participants, including the handling of disputes in relation to trading matters; and (v) cross-market surveillance of HKEx's users.
- 4.36** The trading and clearing functions of the securities and futures markets are centralized in HKEx: it has monopolies in the operation of the exchange-based primary market, the futures exchange, and all clearing operations in Hong Kong. As a result of its public functions combined with its commercial objectives, a comprehensive framework of checks and balances is necessary and is built on the basis of the SFO. In addition, there is a shareholding limit of 5 per cent to prevent control of HKEx by any individual or parties acting in concert. HKEx is regulated by the SFC to avoid conflicts of interest and to ensure a level playing field between HKEx and other listed companies subject to HKEx's listing rules and supervision.
- 4.37** In relation to intermediaries' supervision, HKEx monitors particular aspects of the business of intermediaries in order to allow it to assess and manage relevant risks. The SFC is primarily responsible for routine inspections of HKEx members' businesses, for monitoring their compliance with conduct rules and liquid capital requirements, and for ensuring that members have in place proper systems of management and control.

### (3) Committees, tribunals, and panels

- 4.38** The Advisory Committee is responsible for advising the SFC on policy matters concerning its regulatory objectives and functions. It has no executive powers and does not police the SFC in any way. It is chaired by the SFC Chairman, and comprises the CEO and not more than two other executive directors appointed by the Chairman, and between eight and twelve other members appointed by the Chief Executive of the Hong Kong SAR in consultation with the Chairman of the SFC.
- 4.39** In addition, the SFC has established various regulatory committees to which it has delegated some of its functions, for example:
- Takeovers and Mergers Panel—is responsible for The Codes on Takeovers and Mergers and Share Repurchases. Much of the administration of this Code is in practice exercised by the SFC staff, acting as the Takeovers Executive.
  - Takeovers Appeal Committee—hears appeals against the disciplinary rulings of the Takeovers and Mergers Panel at the request of an aggrieved party for the sole

- purpose of determining whether any sanction imposed by the Panel is unfair or excessive.
- Products Advisory Committee—set up in August 2010 to replace the former Committee on Unit Trusts, and Committee on Investment-Linked Assurance and Pooled Retirement Funds. It advises on matters relating to the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, the SFC Code on Mandatory Provident Fund (MPF) Products, and the Code on Pooled Retirement Funds, including overall market environment, industry practices, and novel product features.
  - Investor Education Advisory Committee—provides advice and support to the SFC in setting investor education targets.
  - Academic and Accreditation Advisory Committee—approves industry-based courses and examinations for meeting the licensing competence requirements, and recognizes providers of training for the purposes of the Continuous Professional Training (CPT) requirements.
  - Share Registrars' Disciplinary Committee—hears and determines disciplinary matters relating to share registrars in the first instance.

The following tribunals and panels are independent of the SFC:

**4.40**

- Securities and Futures Appeals Tribunal—an independent statutory body with full-time members headed by a judge appointed by the Chief Executive of the Hong Kong SAR to hear appeals against the decisions made by the SFC relating to the licensing or registration of intermediaries and certain other matters.
- Arbitration Panel—established under rules made by the SFC as provided for in section 118 of the SFO. An arbitrator will be appointed from the Arbitration Panel to hear disputes in accordance with the Securities and Futures (Leveraged Foreign Exchange Trading) (Arbitration) Rules.
- Process Review Panel—an independent body appointed by the Chief Executive of the Hong Kong SAR to review and monitor the operational processes of the SFC. It reports to the Financial Secretary and recommends improvements to the SFC.

### (4) Interaction with local regulators

The SFC has entered into numerous memorandums of understanding (MOUs) with the Hong Kong Monetary Authority (HKMA), Office of the Commissioner of Insurance (OCI), and the Mandatory Provident Fund Schemes Authority (MPFA) individually and jointly, to coordinate responsibilities and to assist each other in performing their functions efficiently and properly.

**4.41**

*HKMA*

- 4.42** The HKMA's linkage with the SFC principally relates to its supervision of banks, the logical contact being with the deputy Chief Executive (Banking Supervision). This linkage is particularly important in view of the increasing volume of securities and securities-related business conducted by banks in Hong Kong.
- 4.43** Under the SFO and the Banking Ordinance, authorized financial institutions (AFIs), which are regulated by the HKMA and include banks, have to be registered with the SFC as 'registered institutions' if they wish to carry out an SFC-regulated activity. As the frontline regulator of AFIs is the HKMA, the latter takes the leading role in vetting applications for such registration and in supervising their SFC-regulated activities including carrying out on-site inspections. The HKMA applies all SFC criterion, such as the 'fit and proper' criteria, in supervising AFIs registered with the SFC.
- 4.44** The HKMA may refer cases of suspected malpractice by registered institutions' SFC-regulated activities to the SFC, which may directly conduct a review. In respect of regulated activities, the SFC may suspend or revoke the registration of registered institutions and their staff, issue public or private reprimands, and impose fines on both the registered institution concerned and the relevant employees engaged by the registered institution. The HKMA may remove the names of relevant employees, either temporarily or permanently, from its register maintained under the Banking Ordinance. Only those persons named in the register may carry out SFC-regulated activities. Clearly, the HKMA and the SFC must work closely together in relation to any SFC-regulated activities that are carried out by registered institutions. To this end, an MOU has been signed between the two regulators, setting out their roles and responsibilities so as to minimize regulatory overlaps under the regime.

*OCI*

- 4.45** There is a minimal connection between the regulatory activities of the OCI and the SFC—to the extent that insurance intermediaries do not undertake any SFC-regulated activities or that insurance products do not fall within the descriptions of products defined by the SFO. Notwithstanding, there are two classes of funds which are authorized by the SFC which have a connection with the OCI: (i) investment-linked assurance schemes; and (ii) pooled retirement funds; both being marketed by the insurance industry. Authorization of these classes of funds has been delegated by the SFC to the Committee on Investment-Linked Assurance Schemes and Pooled Retirement Funds, which consists of representation by the OCI. Insurance companies wishing to promote these classes of funds need to be authorized with the OCI under the Insurance Companies Ordinance.

*MPFA*

Certain responsibilities of the MPFA interlink with the responsibilities of the SFC. **4.46**  
These responsibilities are to:

- vet and authorize Mandatory Provident Fund (MPF) products and related marketing materials in accordance with the provisions of the SFC Code on MPF Products and the relevant Ordinances (including the SFO);
- registering and approving investment managers and continued monitoring of their conduct in the investment management of MPF products;
- supervising the activities of investment advisers and securities dealers providing services in respect of MPF products;
- investigating alleged breaches of the provisions of the SFC Code on MPF Products and any relevant Ordinances and taking enforcement action; and
- dealing with complaints referred to it by the MPFA or the public about MPF products authorized by the SFC, or the conduct of SFC-licensed persons engaged in the investment management of these products.

**(5) International regulatory cooperation***Overseas regulators*

The SFC is empowered to disclose confidential information to specified persons and organizations in certain circumstances, usually when it is in the public interest or where it will help the recipient to perform their designated functions.<sup>16</sup> The SFC may also provide information to an overseas authority or regulator, generally of financial services, who is subject to adequate secrecy provisions. The SFC will publish the names of such persons to whom it has made disclosures. The SFC has entered into MOUs with a wide range of local, mainland, and overseas regulators covering the provision of mutual assistance in performing their functions. These MOUs also provide for joint inspections and reviews of financial groups with cross-border connections. **4.47**

*International Organization of Securities Commissions*

The SFC and the government have actively sought not only to implement international standards of best practice in Hong Kong's capital markets, but to lead the development of those standards for the rest of the world. The SFC has been active in signing MOU and similar cooperative agreements around the world. Importantly, the SFC continues to be a full, independent, and active member of the International Organization of Securities Commissions (IOSCO). **4.48**

IOSCO is a global group of securities regulators that promotes cooperation and high standards of regulation in order to maintain fair, efficient, and sound markets. **4.49**

<sup>16</sup> For details see, SFO s 378.

## FINANCIAL DERIVATIVES

<b>A. Sources and Uses</b>	8.04	<b>C. OTC Derivatives and Hong Kong</b>	
(1) Classification	8.08	<b>Regulatory Oversight</b>	8.108
(2) Instrument types	8.18	(1) Swaps and structured transactions	8.111
(3) Uses	8.54	(2) Documentation and the role of ISDA	8.112
<b>B. Exchange Traded Derivatives in Hong Kong</b>	8.70	(3) Credit derivatives	8.124
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(2) Margin requirements	8.88	(1) Part IIIA, SFO–OTC derivative transactions	8.133
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(4) Regulatory framework	8.97	(3) Reporting requirements	8.152
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		(5) Trading requirements	8.169

Derivative contracts and instruments containing embedded derivative components are widely dealt or held in Hong Kong just as in other major financial centres, and most of the legal and regulatory concerns that flow from the use of such contracts by intermediaries and other market participants are little different from elsewhere. Hong Kong has diverged in one important respect since the early 1990s from other jurisdictions, however, in hosting a disproportionately high volume of retail participation in financial derivatives, mainly through structured notes (discussed in Chapter 7), and exchange traded option products that give leveraged exposure to local equity prices. Growth in issuance and trading of several such instruments made Hong Kong Exchanges and Clearing Limited (HKEx) the world's most active single market in third-party covered warrants ('derivative warrants' in HKEx terminology) by the mid-2000s, and Hong Kong to rank second only to Germany as a domicile for such trading, despite a population only one-twelfth as large. This phenomenon gives an unusual focus to Hong Kong's approach to investor protection and business conduct rules, which has intensified since 2009–10. **8.01**

Some derivative products are both comparatively new and complex in their risk management, capital adequacy, and investor protection demands, and at intervals since the 1980s regulatory practice in several jurisdictions has responded to **8.02**

prominent cases of the misguided or misinformed use of derivatives, often by commercial parties typically assumed in law to be relatively sophisticated. The collapse of Lehman Brothers in 2008 is one notorious such example for three reasons, one carrying especial relevance in Hong Kong. First, Lehman's bankruptcy paralysed many wholesale financial markets as intermediaries became fearful of unquantifiable counterparty risks, with the capacity of derivatives to redistribute risk suddenly perceived as increasing overall opacity rather than encouraging safety and stability. Second, resolving Lehman's estates in bankruptcy was made complex by a web of derivative contracts outstanding between Lehman entities in several jurisdictions and their commercial counterparties, and by conventional conflicts of laws in the priority given to claims under derivative contracts, especially between the courts in England and New York. Third, the sales success of Lehman's Minibond reitailed structured note programme in Hong Kong (as well as in Singapore and Taiwan), introduced those problems of contractual complexity and conflicts of laws to Hong Kong's large and vocal community of small investors, much to the discomfort to its financial regulators.<sup>1</sup> The territory's response to the legal and regulatory questions posed by these events conforms in some measure with the reforms promoted since 2009–10 by the Financial Stability Board (FSB) and adopted by most advanced economies, but in stipulating appropriate conduct for intermediaries it extends beyond the recommendations of the International Organization of Securities Commissions (IOSCO).

- 8.03** This chapter describes the main current forms of derivatives contracts, their uses and risks, and examines Hong Kong's approach to their regulation. It also raises questions that may not be fully addressed in any major financial jurisdiction; for example, how the law accounts for relatively new, sophisticated contracts, especially in relation to user protection; whether related areas of law such as bankruptcy may conflict with what has become customary derivative market practice; and how credit risk transfer facilitated by derivative instruments may conflict with established precepts of financial regulation. Lastly, it considers the implementation of post-crisis derivatives re-regulation, which in Hong Kong and elsewhere is requiring the most profound changes of the modern era in contract execution and administration.

### A. Sources and Uses

- 8.04** Trends in financial globalization are commonly seen as manifested in a blurring of divisions, be they segregated markets or national borders. What Richard O'Brien calls the 'End of Geography' is not a finite limit, but a progression along which

<sup>1</sup> See P Lejot, 'Dictum Non Meum Pactum, Lehman's Minibond Transactions', (2008) 38 *Hong Kong Law Journal* 3, 585.

financial activity is increasingly less acquainted with any particular place.<sup>2</sup> At the same time, many financial products have assumed qualities of fungibility historically associated with cash. Just as two ordinary shares in a company are perfect mutual substitutes, so relatively new instruments or applications may give de facto ownership rights to the creditor, or priority of claim to the shareholder, even while debt and equity claims may wholly differ in tradition and law. All these transformations are made possible by derivative instruments. Each involves changes over time in combinations of expected risk and return for market participants, whether associated with credit risk, currencies, insurance, commodities, interest rates, shares, or financial indexes, and whether contracted singly, in combinations, or as an indistinguishable part of a structured transaction.

Certain derivatives have been known for centuries:<sup>3</sup> primitive commodity forward contracts were bought and sold in medieval Europe and organized futures or options markets existed in Japan by the late sixteenth century. Other instruments appear and vanish according to financial fashion.<sup>4</sup> All are more easily characterized by use or availability rather than defined as a market segment: derivatives are often evidenced by simple private law contracts but the risk management techniques that lead to their creation, aggregation, and maintenance may be immensely sophisticated. Financial derivatives use the language of calculus and many are priced using differential functions, to imply instruments whose price is determined as a function of the value from time to time of an underlying contract, security, or index, but this may not always be true, and the 'theoretical' integral may be long lost to history. For example, simple fixed-floating interest rate swaps were once priced (thus 'derived') from continuous chains of forward short-term interest rates and a comparison of the conventional borrowing costs of two dissimilar counterparties, yet today's global interest rate swap markets in major currencies are so large and liquid that the swap yield curve is itself a strong influence on the pricing of loans and bonds. The derived product thus becomes the source. In this way is seen the challenge for law and regulation in keeping pace with product development.

Although this chapter explains important aspects of derivative instruments and the risks and markets with which they are linked, its approach adheres to the central aims of this volume, and is neither technical nor comprehensive as to risks or

<sup>2</sup> London: Royal Institute of International Affairs, 1992.

<sup>3</sup> Writing in the fourth century BCE, Aristotle describes an option strategy involving the forward purchase of olive oil pressing capacity; *Politics* I xi: 4 (1259<sup>a</sup>6–23). Contracts for the sale of goods or chattels for future delivery existed in the Middle East in the second millennium BCE and it has been claimed that a sample of such contracts closely resemble certain instruments in use today (E Swan, *Building the Global Market: A 4,000 Year History of Derivatives* (London: Kluwer, 2000), pp 31–48). Section A is adapted from Q Liu, P Lejot, and D Arner, *Finance in Asia: Institutions, Regulation & Policy* (Abingdon: Routledge, 2013), pp 334–70.

<sup>4</sup> Typified by structured notes with periodic coupons designed to meet the interest rate expectations of specific investor classes in particular prevailing conditions. Similar motives frequently drive bespoke issues negotiated with high net worth investors through private banks, but also influence retail targeted warrants, a prominent feature of derivatives activity in Hong Kong.

products. Hong Kong is an important centre for users of certain derivatives<sup>5</sup> but in most operational respects it is technically indistinguishable from other financial hubs where derivatives are bought, sold, or conceived, even in respect of contracts based on HK dollar instruments or indexes. Instead, the chapter's contents reflect two aspects of derivative market activity in Hong Kong: first, the relative prominence of retail-orientated derivative products, that is, those intended for transaction by end-user individuals and companies in small nominal amounts, and second, how the Hong Kong authorities regulate derivatives activity among financial intermediaries operating in the territory.

**8.07** The two topics are related in that the effect of the first is to give an investor protection and issuer risk management focus to the second. Hong Kong's approach to wholesale market regulation is now representative of most leading financial centres. The chapter first examines instrument classifications, types, and gives examples of uses to which financial derivatives are put. It describes risk features arising from the two elementary categorizations of financial derivatives, and last, focuses on important aspects of Hong Kong's approach to the regulation of these two classes of derivatives.

(1) Classification

**8.08** All derivatives are evidenced by private law contracts. Some will be negotiated separately among their counterparties but most are subject to standardization of documentation that results from their either being traded on an organized exchange, or made to conform with the global harmonization of market practices brought about by the sector's self-regulatory organization (SRO), the International Swaps and Derivatives Association Inc. (ISDA). The common law treatment of derivative contracts is to regard as legal and enforceable almost all of those made among professional parties or on an organized exchange, but care is needed in contract drafting to ensure that all claims outstanding remain valid throughout the life of any transaction, the reason being that most derivatives are not borrowing contracts and create no principal debt.

**8.09** Derivatives can be classed in four types according to how they are bought and sold and whether they are based on forward or option contracts. Figure 8.1 shows how a selection of common derivative products divides among these categories.<sup>6</sup>

<sup>5</sup> Ranked twelfth by turnover in aggregate over-the-counter (OTC) single currency interest rate derivatives in the 2013 Bank for International Settlements (BIS) triennial survey of derivative market activity, such contracts being by far the largest component of the OTC derivatives markets. However, Hong Kong's market share was a mere 1.0 per cent of the total, as turnover is heavily concentrated in the United Kingdom and United States, with respectively 48.9 per cent and 22.8 per cent of turnover). Data available at <<http://www.bis.org/publ/rpfx13.htm>> accessed 20 November 2015. Hong Kong is not prominent as a centre for exchange traded derivatives other than for covered warrants.

<sup>6</sup> Figure 8.1 shows examples and is not comprehensive. Note that options may exist on each instrument shown. 'Stock' refers to an equity security.

Over-the-counter contracts		Exchange-traded contracts
FX forwards, FX swaps, forward rate agreements, interest rate swaps, basis swaps, currency swaps, cross-currency interest rate and basis swaps, commodity swaps, forward swaps, amortizing swaps, total return swaps	Forward contracts	FX future, stock index futures, commodity futures, metal futures, shipping futures, energy futures, stock futures, interest rate future, government bond futures, interest rate spread futures, interest rate swap futures
Interest rate caps and floors, swaptions, forward swaptions, callable swaps, credit default swaps, extendible swaps, differential swaps	Option contracts	FX options, stock index options, stock options, equity warrants, government bond options, currency warrants, debt warrants

Figure 8.1 Classification of derivatives

Exchange traded derivatives

Exchange traded products are bought and sold in each case on a single organized exchange. These maintain operational resources but with a few exceptions no longer provide physical meeting places or 'floors' for trading. All exchanges entail centralized clearing, settlement, the maintenance of collateral margins, and the reporting of trades and prevailing prices. The exchange, of which the Hong Kong Futures Exchange (HKFE, part of HKEx, which also owns the Stock Exchange of Hong Kong (SEHK)) is an example, acts as a central counterparty (CCP) through one of two subsidiaries,<sup>7</sup> that is, the contracting party to all derivatives for which the exchange provides the trading forum. Contracts are standardized as to commercial terms, notably their scale of interest in underlying assets from which they derive, as are the processes of dealing, settlement, and certain risk controls, most particularly the requirement that contract holders place defined settlement margins with the exchange against outstanding contract positions in the form of cash or risk-free securities. On any day, the margin demanded of a contract holder is typically the sum of fixed amounts posted upon dealing and others required to be made during the life of the contract depending upon its mark-to-market value. The exchange's rules may allow the margin to be set off in defined circumstances against the settlement obligations of the contract holder, and retained if the contract holder fails to respond to demands that it be increased. In all cases, end-users deal through exchange members.

Over-the-counter derivatives

Over-the-counter (OTC) derivative contracts have traditionally been dealt and settled among financial intermediaries and their clients, rather than centrally. Some banks assume the role of market makers in relatively liquid products, but trades are negotiated directly between counterparties, so the nature of counterparty credit risk has historically differed from that associated with exchange traded

<sup>7</sup> Stock Exchange of Hong Kong Options Clearing House Co. and Hong Kong Futures Exchange Clearing Corporation.

contracts. OTC derivatives lack standardized margin requirements but financial intermediaries require that almost all clients maintain liquid collateral against the mark-to-market valuation of the contract whenever it represents a net credit risk, the value established by convention as the present value of future net payments due under the instrument. These practices — largely developed by ISDA in cooperation with market participants and national regulators — are undergoing profound changes due to FSB-led reforms, with the result that the great majority of OTC contracts will be reported to approved trade repositories (TRs) and cleared centrally; that CCPs become party upon execution to all contracts taking standard forms and conditions; that CCPs hold and administer collateral to support the ensuing price variation risks; and that parties to non-standardized contracts that cannot readily be centrally cleared and administered will be subject to specific collateral and capital requirements. The FSB has reported that most of its twenty-four member jurisdictions will have implemented the reforms requiring centralized reporting and clearing by end-2016.<sup>8</sup>

#### *Forward contracts*

- 8.12** Derivatives based on forward contracts require the user to buy or sell an underlying asset at a certain price upon expiry of the contract on a specific forthcoming date. Futures are those forward contracts that are traded on an exchange. The essence of all forward contracts is a sale or purchase struck today at a fixed price for settlement at a specific later date. It thus includes outright foreign exchange forwards, involving the future sale and purchase of currency against a second at a rate determined at the time of dealing, as well as commodity futures, by which a farmer can sell a fixed amount of produce or livestock, for example, for physical delivery at a later date at prices set upon dealing. In each case, the forward price is determined by the spot transaction price and net cost of carry, that is, the difference in receipts and expenses accruing on an asset owned today ('spot') and later ('forward').

#### *Option-based contracts*

- 8.13** Options contracts allow the holder to choose to sell or buy an underlying asset at a certain price on or before a specific forthcoming date. In their elemental form, options are either calls or puts, which convey the right to buy and sell respectively, the subject asset, but in neither case the obligation so to do. Both call and put options may be bought (by the 'holder') or sold (by the 'writer'), so that it is possible for the seller of a put and the buyer of a call to face identical combinations of risk and return. Many common option-based trades involve combinations of calls and puts in ways that produce a return in specified conditions, for example, if underlying asset prices move within a set range.

<sup>8</sup> Including Hong Kong, see FSB, 'OTC Derivatives Market Reforms: Tenth Progress Report on Implementation', (4 November 2015), pp 4–5, 8–9.

Thus the most obvious difference between forwards and options is the volition **8.14** given to the option contract holder, that is, a contractual entitlement rather than an obligation. The distinction between forward and option-based instruments is also shown in the mathematical relationship that each has with its respective underlying instrument. Forward-based derivatives are linear functions of an underlying asset, so that a price change in that asset causes a proportionately identical change in the prevailing price of the derivative. Option-based derivatives are non-linear functions of their corresponding underlying asset, so that a 1 per cent change in that asset's price may cause a far greater proportional change in the derivative's prevailing price.

Further, the nature of forward-based derivatives is that price losses and gains in **8.15** their underlying instruments always have an equally large, or symmetrical, impact on the prevailing price of the derivative, that is, it is mechanically equally possible to gain as to lose. By contrast, option-based derivatives are both non-linear and asymmetric functions of the value of the underlying instrument. First, a price change in the underlying asset will cause a disproportionate change in the price of the derivative. Second, the magnitude of price gains and losses in the derivative are unlike, given price gains or losses of equal size in the underlying instrument. Price asymmetry contributes further to the leverage associated with options of all kinds. The leverage implicit in much trading in option-based derivatives is the justification for margin requirements typical of derivative exchanges, and helps explain notorious cases such as the near-collapse of Metallgesellschaft AG in 1993 and the fall of the Barings group in 1995, both coming quickly to crisis. In each case option-based trading losses resulted in substantial margin calls on the companies' respective United States and Singapore subsidiaries, which for Barings exceeded the total financial resources of the group.<sup>9</sup>

#### *Combined and embedded derivatives*

Other transaction instruments, some of them commonly used by retail participants or financial intermediaries, represent either combinations of two or more of **8.16** these examples, or the inclusion of a derivative element in a non-derivative setting. Thus in the first case, a forward interest rate swap is usually a combination of two conventional interest rate swaps of different tenors; a futures or options straddle is the simultaneous sale and purchase of futures or options contracts respectively, to protect the holder against sizeable price movements in the underlying asset. In the second case, most traditional convertible bonds are simple fixed rate debt instruments with share options intrinsic in their structure. While this chapter contains

<sup>9</sup> Metallgesellschaft lost US\$1.3 billion from misapplied hedging. Barings involved failures of risk management and regulation and is well-documented in 'Report of the UK Board of Banking Supervision inquiry into the circumstances of the collapse of Barings', London, HMSO 1995, and by reported English cases, e.g. *Re Barings plc and others (No. 5)*, *Secretary of State for Trade and Industry v Baker and others (No. 5)* 1 BCLC 433. The report's findings quickly proved widely influential in legal and regulatory supervisory reform.



examples of transactions involving embedded options, its main concern is with the regulation of exchange traded and OTC derivatives, whether forward or option-based instruments.<sup>10</sup>

- 8.17** These categories help simplify the roots of regulation in Hong Kong, given that the great majority of retail derivatives are option-based, exchange traded, and often marketed broadly among non-professional participants. Applicable regulation is directed through the exchange, and concentrates on rules in respect of listing, selling, and margins. In contrast, derivatives regulation for financial intermediaries centres on capital sustainability after transaction loss, which the Basel accords characterize as the manner in which capital is maintained against market risks. This has entered Hong Kong law in the form of schedules to the Banking Ordinance and applies to all Authorized Institutions, as defined in the ordinance.<sup>11</sup> It also relies on the international harmonization of market practice standards that has accompanied the growth of the modern swap markets since the early 1980s, reflecting the central role assumed by ISDA, especially in promoting the standardization of documentation, collateral requirements, and settlement processing, and of general acceptance of common capital equivalent risk calculations.

## (2) Instrument types

- 8.18** This section explains the generic derivative instruments most commonly used in Hong Kong and other major financial centres, and which are examined from a legal and regulatory perspective later in the chapter. It excludes derivatives categorized by the Bank for International Settlement (BIS) as traditional foreign exchange derivatives, that is, outright forward contracts (contracts for the forward sale or purchase of foreign currency) and foreign exchange swaps (simultaneous spot sale and forward purchases of one currency for a second).

### *Exchange traded derivatives*

- 8.19** Exchange traded derivatives are identical, fungible instruments specified according to their underlying asset, contract duration, and the settlement requirements of the exchange on which they trade, that is, HKFE for contracts offered in Hong Kong. Standard specification implies that few contracts will match the needs of all users but the same factor tends to result in greater market depth, tradability, and liquidity. Settlement of all exchange traded derivatives was once made by physical delivery of underlying assets, the result of the markets' commodity dealing origins when physical delivery was usually desired, but the trend since the 1980s has been towards financial contracts being settled for cash. This lessens the chances of

<sup>10</sup> Not considered here are asset-backed securities (ABS), which have been regarded as derivative products by some national regulators (including Hong Kong) for which practice, taxation, applicable law, and regulation are those applying to other debt securities.

<sup>11</sup> Cap. 155 s 2; the treatment of capital is given in sch 3. See also Chapter 3, Section D(3).

market manipulation, prevents highly leveraged contracts becoming impossible to settle for lack of deliverable assets or willing sellers of such assets, and limits distortions between the terms of contracts and underlying assets.

Typical exchange rules demand that futures and options positions are marked to market each day, with gains and losses (which sum to nil for each contract type) paid to the exchange according to formulae specified for each contract. The exchange clears these payments daily and thus eliminates all aspects of counterparty exchange risk for traders. This mark-to-market margin system means that the value of stock futures is reset on each trading day. Exchanges (including HKFE) accordingly require payment of an initial margin when a contract position is opened, together with a maintenance margin that varies with the contract price and is thus a function of the price of the underlying share. Margins may not fall below preset minimums.

Whenever general user demand proves commercially inadequate, contracts will fail and be withdrawn from trading unless a strategic interest requires otherwise, as has been the case with certain HK dollar interest rate contracts, which are sustained despite sporadic low usage. HKFE's contract experience is mixed.

### *Stock options*

Call options give the holder the right but not the obligation to buy a fixed quantity of an underlying asset at a fixed price (the 'exercise price') on, and in some cases up to and including, a given date. Put options confer to the holder the right but not the obligation to sell a fixed quantity of an underlying asset at a fixed price on, and in some cases up to and including, a given date. The call seller (writer) has a corresponding obligation to deliver the underlying asset (not normally its cash equivalent) at a fixed price to the call buyer. Similarly, the put writer (seller) is obliged to buy the underlying asset at a fixed price from the put buyer. Most options will be one of two types: American-style options can be exercised at any time before expiry, while European-style options may be exercised only at expiry.<sup>12</sup>

The specification of stock options comprises:

- Underlying asset, that is, the share upon which the option contract is written.
- The number of shares to which a single option relates. This is usually the minimum dealing amount (the 'board lot') of shares.
- Exercise ('strike') price, or the price at which the underlying asset may be dealt. The exercise price is said to be 'in the money' if it is below the prevailing asset's price, or 'out of the money' if it stands above that prevailing price.

<sup>12</sup> This distinction applies universally to all options. A small proportion of contracts known as Bermuda-style options may be exercised on a specified series of dates.

- Expiry (or maturity) date; the date on which the option expires or the last date on which an American-style option may be exercised.
- Option premium; the price paid by the buyer to acquire the rights conveyed in the option.

**8.24** Stock options are usually insulated from major capital changes in their underlying stocks to exclude the effect of rights issues, bonus issues, or unusually large dividends. This is done by adjusting the contract size and strike price to maintain the option's value. However, stock options are not protected from ordinary cash dividends.

#### *Stock futures*

**8.25** Stock futures contracts are commitments to buy or sell the cash equivalent of a number ('contract multiplier') of shares at a predetermined price ('contracted price') on a specific future date. There is no alternative of physical delivery of shares upon expiry. At expiry, profits or losses are paid to the accounts of buyers and sellers in amounts equal to the difference between the contracted price and the final settlement price multiplied by the contract multiplier.<sup>13</sup> Stock futures allow short positions on shares to be created or closed relatively cheaply, regardless of how costly it may be to borrow stock in the underlying cash share market. Standardized contracts allow open (uncovered) short positions to be closed (covered) at any time before expiry. Liquidity is maintained by professional market makers who post firm prices at a maximum bid-offer spread set by the exchange.

#### *Warrants*

**8.26** Warrants are tradable option contracts and are issued for profit or to lessen costs by companies, banks, or investors, often as single transactions, and sometimes as part of structured or on-going financing transactions. Simple warrants convey the right but not the obligation to buy (call warrants) or sell (put warrants) an underlying asset (or its cash equivalent) at a predetermined price. Many warrants are sophisticated combinations of calls and puts intended to deliver a particular risk-return combination to the holder, for example, to produce a return if a share price or index follows a specified path during a defined period. Usually (but not always) listed and traded on an exchange, warrants are bought and sold for cash, or as part of consideration in a larger fund-raising transaction. Warrant issues have lives ranging from several months to many years but any single warrant is cancelled upon being exercised by the holder according to the warrant issue's commercial terms.

**8.27** The profit ('payoff') of a call warrant on expiry is the greater of nil and the then closing price less the exercise price multiplied by the subscription ratio. The payoff

<sup>13</sup> HKEx's formula for final settlement price is the average of the mid-points of the best bid and offer prices quoted for the underlying stock at five-minute intervals during the last contract trading day.

of a put warrant on expiry is the larger of nil and the exercise price less the closing price multiplied by the subscription ratio. The subscription ratio (or entitlement ratio) is based on the number of warrants needed to convert into one nominal unit of the underlying asset. Closing prices are usually taken as averages over several days immediately prior to expiry. These and all other commercial terms are included as part of documents submitted at the time of listing.

Historically, warrants were first issued in the 1970s as part of financing transactions, most often bond issues, as a means to lower an issuer's borrowing costs, either before or after tax. Every ten bonds might carry one warrant, entitling the holder to buy a set number of shares in the issuer at a fixed price, or the right to acquire more bonds, for example, on predetermined commercial terms. Since investors could attribute value to the warrants when the transaction was launched, the effect of including warrants in a transaction as sweeteners in this way would be to lower the overall cost to the issuer of servicing the host bond. Moreover, the warrants could be detached ('stripped') and thereafter bought or sold separately from the host bonds so as to appeal especially to risk-preferring investors.<sup>14</sup> Their main appeal matches those of all option-based instruments, to offer a leveraged risk exposure compared to the underlying asset. While warrants can be linked to any asset or index for which there exists a market price, they now take two basic forms depending on whether or not the warrant is issued by the obligor of the underlying asset or by an unconnected third party, usually a bank or securities house. The latter, known as covered or derivative warrants, have become especially prominent in Hong Kong for reasons generally associated with domestic retail investors.<sup>15</sup>

#### *Covered (derivative) warrants*

Covered warrants are tradable option contracts issued as discrete transactions by banks and others parties that have no ownership connection to the obligor of the underlying asset or risks. In the form most common in Hong Kong, a bank<sup>16</sup> will issue covered warrants for cash consideration that entitle the holder, upon exercising the warrant prior to its expiry, to receive a cash settlement determined by a formula that is a function of the prevailing price of shares in a listed company or an

<sup>14</sup> The same tactic is applied to convertible bonds by synthetically separating embedded options from the straight bond component, and selling the resulting two products as option contracts and asset swaps.

<sup>15</sup> This chapter discusses warrant types most commonly used in Hong Kong. It refers mainly to 'covered' or 'derivative' warrants as those issued by third parties without control of an underlying share or market risk. Previously (i) in the mid-1990s, 'covered' could refer to warrants whose issuer was also the issuer of underlying shares; (ii) 'non-collateralized' warrants were issued by third parties unconnected to the underlying asset and were first issued and listed in 1989; and (iii) in 1994-7 'call spread' warrants were popular with local retail investors and are similar in construction to today's covered (derivative) warrants. See also P Lejot, 'Cover Up! Hong Kong's Treatment of Covered Warrants', (2006) 36 *Hong Kong Law Journal* 3, 266.

<sup>16</sup> Permissible issuers are set out in HKEx Listing Rules chapter 15A albeit ambiguously.