

FINANCIAL LEGAL INSTITUTIONS IN HONG KONG'S TRANSITION

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On July 1, 1997, China resumes its exercise of sovereignty over Hong Kong. Historically, this is an important date. In practical terms, the day signals a transition to the "one-country, two-systems" concept. It is therefore particularly apt that financial and legal institutions are brought together on the occasion of this Symposium.

1. THE NEED TO LOOK AT FINANCIAL AND LEGAL INSTITUTIONS TOGETHER

To even the most cursory student of financial and legal institutions, it would be quickly apparent that there is a necessary nexus between the two. The financial institutions of any society facilitate the transfer and creation of wealth, but wealth itself must be secured by property relationships which, in turn, must be defined by every society and protected by its legal institutions. Hence, financial institutions cannot exist without legal institutions and there would be little reason for legal institutions to exist were it not for the common purpose of the pursuit of wealth, happiness, and security.

Ever since the Industrial Revolution in the Western world, the world as we know it today would not have been possible were it not for the fact that institutions have been invented for the accumulation, deployment, and transfer of capital. The invention of the joint stock company and the public offering and trading of shares, the establishment of financial and commodity futures markets, and the growth of banking and collective investment all serve to direct wealth surplus to the needs of individuals. This has been the quest of society so far and will remain so for the foreseeable future. That is why there is continual, earnest questioning within each society as to the function of the financial markets.

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2. MARKET CULTURE

Hard questions have often been prompted by cataclysmic events, such as the market crash of 1929 in the United States and the more recent crash of 1987. Economists would frame these questions in terms of efficiency. Jurists would ask whether there was anything in market institutions which offended generally accepted notions of justice and fairness. The way these questions have been answered by each society determines its market culture. Thus we have different market cultures around the world.

The United States' answer to these questions came in the form of the Glass-Steagall Act, which disallowed commercial banks (which as deposit-taking institutions are deemed to be required to act as bastions of prudence) from engaging in the risky business of underwriting securities offerings, and, of course, by the landmark Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. To this day, the fundamental philosophies of this legislative framework determines the market culture in the United States.

The United Kingdom has largely relied, even to this day, on self-regulation. In 1986, the year of the 'big bang,' however, they opted for self-regulation assisted by a statutory structure in the form of the Financial Services Act. The European Union has also made inroads in pan-European financial regulation by successive directives in banking, investment services, and standards for capital adequacy. The Asian markets, including those in Australia, have developed their own particular market cultures over time.

3. THE NEW CONTEXT IS GLOBALIZATION

The continuing globalization of the markets requires each market to continuously rethink its regulatory system. Regulation today is a dynamic process requiring every society not only to think of its own needs but also the needs of other societies.

The globalization of the markets has been the result of two important developments. First, the breakdown in barriers to capital flows. Second, continuing and rapid advances in technology. Electronic international payments systems now make it possible for international fund transfers to be made instantaneously, and multi-currency payments to be completed within a matter of hours. A worldwide web of custodians and depositories of financial instruments enable delivery to be made against payment

within three days of a transaction, a universal standard first recommended by an influential industry group now known as the Group of Thirty. Trading derivatives, on any scale and in any degree of complexity, would have been impossible without the software and computer processing power available today.

The consequence of all this is that losses in one market thousands of miles away can mean financial ruin for even venerable financial institutions within a very short time, as was seen in the case of Barings Brothers. These developments make every market think hard about old assumptions and, more particularly, about what is common among them. With increasing globalization, there is going to be more and more which is common among markets. Hong Kong is deep in the middle of this ferment of thought.

4. HONG KONG AS AN INTERNATIONAL FINANCIAL CENTER

Hong Kong is the freest and most open international financial center in the world. Many world renowned studies (such as those conducted by the World Economic Forum, the Hoover Institute, and the Heritage Foundation, and successive National Treatment Studies by the US Government) have so concluded.

Capital flows freely in and out of Hong Kong. We are thus very much part of a growing interdependent global financial system. To illustrate that Hong Kong and the rest of the world are highly dependent upon each other, I need go no further than foreign exchange dealings. Hong Kong's foreign exchange markets deal on a twenty-four basis around the world. These markets average US\$91 billion a day in spot foreign exchange dealings alone (the derivative markets in currencies adds another US\$56 billion a day), making it the fifth largest foreign exchange center in the world. But like all international financial centers, Hong Kong and those who deal with it have to take the mutual risks involved in these (and indeed other) financial transactions, namely credit risk, settlement risk, market risk, legal risk, and regulatory risk, to name but a few. We are therefore constantly kept aware of the fact that we are but one of the elements in a global financial village. We are closely interdependent because capital flows freely between us. Yet by the same token, we compete because each of our markets has to reckon with the free choice of investors and those who seek them. Hong Kong has been no stranger to this phenomenon.

Take our listed companies for example. In 1984, the Jardines group, after nearly 140 years in Hong Kong, decided to change its corporate domicile to Bermuda. The Hong Kong Stock Exchange, then listing only domestic corporations, decided to change its rules to allow Jardines to continue to list. Since then, Hong Kong's Stock Exchange has played host to an increasing number of foreign domiciled companies. In fact, nearly sixty percent of the 567 companies currently listed on the Hong Kong Stock Exchange are foreign domiciled companies.

5. TURNING ADVERSITY INTO A VIRTUE

Faced with a flight of companies to Bermuda, Hong Kong turned potential adversity into a virtue by making its listing rules sufficiently flexible to accommodate foreign domiciled companies. Jardines has since left the Hong Kong stock market, but the result to date of Hong Kong's response to potential adversity is a stock market with a market capitalization of US\$350 billion, the largest stock market in Asia outside of Japan, and the eighth largest in the world.

Ever since the Hong Kong Stock Exchange overhauled its listing rules to allow overseas domiciled companies to be listed provided they fulfilled required standards of shareholder protection and disclosure, these standards have consistently been improved so that many Hong Kong public securities issues are now globally offered. In fact, there are a growing number of cross listings between the Hong Kong Stock Exchange and the New York Stock Exchange, notable examples including some of our major blue chip companies and a number of Chinese state-owned enterprises, which would not have been listed in Hong Kong and New York but for the fact that they were able to comply concurrently with the standards of these two jurisdictions.

6. THE APPLICATION OF INTERNATIONAL STANDARDS

As we are undoubtedly part of the global market, we have no choice but to apply international standards in all fields of financial regulation. On the banking side, Hong Kong was one of the first Asian markets to adopt the Basle Capital Rules and last year became the first Asian market to announce application of the Basle Market Risk Capital Rules. The importance of Hong Kong as an international banking center was recognized by the Bank of International Settlement vis-a-vis its recent invitation to the Hong

Kong Monetary Authority, along with eight other Asian central banks, including the People's Bank in Mainland China, to join a hitherto select club of Organization of Economic Co-operation and Development ("OECD") central bankers.

On the securities and futures front, Hong Kong has, since at least 1987, applied standards developed by the International Organisation of Securities Commissions ("IOSCO"), the principal international forum for the development of internationally recognized standards of regulation. IOSCO has in recent years made important strides, in which Hong Kong has actively contributed. The fact that the Hong Kong Securities and Futures Commission has recently been elected to chair the Technical Committee, the key Committee in IOSCO charged with the development of international standards, underscores recognition of our commitment to this important task. This commitment is at the same time bolstered by bilateral regulatory agreements between Hong Kong and all the major markets of the world. We have at this moment a total of 28 such agreements, including two with the securities and futures regulator on the Chinese Mainland. In the United States, we have strong ties with the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), cemented by a regulatory agreement last year.

7. MARKET DEVELOPMENT IN HONG KONG

As Hong Kong must compete internationally, applying internationally recognized standards and building regulatory linkages are not by themselves sufficient. Investors generally choose to invest in markets that are liquid, efficient, transparent, and replete with all kinds of investment and risk transfer products. It is here that Hong Kong has spent the most effort and resources in the past seven years by the establishment of central clearing, a central depository for shares, automated trading systems in the stock and futures exchanges, and the launching of exchange traded derivatives. At the same time, our financial prudence rules take account of the use of "state of the art" financial risk models in use in international firms.

The regulatory linkages we have built now make it possible for markets in Hong Kong and elsewhere to link and pool their liquidity and resources. A link-up between the currency options market of the Philadelphia Stock Exchange and our Futures

Exchange, and between the New York Commodities Exchange and our Futures Exchange, are in the final stages of preparation. Our regulatory linkages with China have now established Hong Kong as the undisputed principal capital raising place for Chinese companies.

Perhaps due in part to both the business opportunities in the region and the new market infrastructure and the application of international standards, we have also seen our international financial institutions increase dramatically in the past ten years. On the investment side, there were 46 mutual funds authorized for public sale in Hong Kong in 1978. In 1985 there were 161. In 1995, there were 1,183 domiciled in over 20 countries. In 1996, there were over 1,300 domiciled in just as many countries. There are now nearly 100 registered fund management firms in Hong Kong employing some 600 registered investment advisers. Hong Kong is now the largest fund management center in Asia outside of Japan and, arguably, the largest international fund management center in Asia.

On the "sell side" of the business, Hong Kong plays host to major financial institutions from the United States, the United Kingdom, the European Continent, Japan, Taiwan, the mainland of the People's Republic of China, and other Asian countries. On the banking front, there are 154 international banks operating in Hong Kong. In the securities and futures area, there are over 1,600 firms and over 16,000 individuals registered. Name almost any major international firm from any jurisdiction, and more likely than not, they are among our registered firms.

8. FACING COMPETITION

One may ask where all of this places Hong Kong as a competitive market. An answer can be found in a recent report by the Nomura Research Institute ("NRI"), which sets out the requirements of a competitive international financial center as follows:

- Efficient markets;
- Capacity for innovation;
- Good range of human resources;
- Wide use of the English language;
- Political stability, including an effective legal system;

- Good market reputation;
- Good business infrastructure, including low taxation and a reasonable cost structure; and
- Good quality of life.¹

The World Economic Forum has in the last three years surveyed the world's economies for their relative competitiveness using these and other indicia, and have each year found the United States, Singapore, and Hong Kong at the top of the list. That means that Hong Kong not only has all the indicia that the NRI has indicated are required for a competitive international financial center but has actually been listed, at least by this survey, as being at the forefront of competitiveness in the world.

It is, however, axiomatic that since we live in a fast-changing world, where capital knows no borders and choice reigns supreme, no international market can retain its competitiveness without being attentive to the needs of investors and the raisers of capital. That is why we shall need to constantly listen and innovate, and to keep our antennae tuned, our senses keen, and our reactions quick. But it is only when we truly understand the root of our success that we are able to grow strong. Let me then ask the question and attempt an answer.

I think that a good case could be made that it is the openness which pervades our society that is truly at the root of its success. This openness may be seen not only at the level of trade and flow of capital. It is part of our everyday life. It enables us to look at change not as threats but as opportunities and fills Hong Kong with the air of dynamism which few fail to experience soon after landing at Kai Tak Airport, itself soon going to be replaced by an airport for the 21st Century.

This dynamism is the result of a sense of security where everyone feels that property, life, and liberty will be protected, that decisions which affect the commonweal are publicly discussed and criticism of these decisions no matter how harsh may be freely expressed, that public servants are publicly accountable for their actions and may be amenable to challenge in the courts where necessary, that the government is by and large unobtrusive and efficient, and that if any legal right is threatened there is

¹ See Yasuyuki Fuchita & Sadakazu Osaki, *Asia's Securities Markets in the 21st Century*, 4 NRI Q. 62, 73 (1995).

recourse to an independent legal profession capable of getting justice from an independent judiciary. Some may wonder what is so special about this, asking rhetorically, "what is the big deal?" After all, this is what all democracies would take as a given. Let me assure you: it is a big deal for us.

A collective sense of security is not built overnight and cannot be guaranteed by even the most complete of written constitutions. That we have built this collective sense of security in our legal and governmental institutions has been the sum total of the culture that has been built over 150 years of evolution of a community given a very special chance in history for East to meet West and for West to meet East, to learn and to live with each other's developing cultures and thereby enable both to prosper. This is a culture which continues to evolve. With the globalization of markets and communications, I am certain that Hong Kong will be one of the most interesting cities in the 21st Century.

9. THE LEGAL INSTITUTIONS BEYOND JULY 1997

The Joint Declaration between the United Kingdom and the People's Republic of China and the Basic Law, Hong Kong's future constitution, explicitly build on this evolving culture. In 160 articles, the Basic Law sets out the future institutions of the Hong Kong Special Administrative Region ("S.A.R."). They are familiar provisions because they by and large seek to codify our current way of life. In particular, they recognize Hong Kong's position as an international financial center and mandate the free flow of capital, an independent monetary and taxation system, and a regulatory environment conducive to international transactions. As the markets of the world globalize, there are essential conditions for Hong Kong to grow in the future.

The provisions in the Basic Law that have been contentious are those provisions which involve the relationship between the S.A.R. and Central Government. It is perhaps ironic that those provisions which are far less over-reaching in their scope than the residual prerogative powers of the British Crown both in Hong Kong and the United Kingdom should become a point of contention. But I am not dismayed by this. There is contention because these are untested ideas whereas British constitutional law and practice have been tested over the past 150 years. The earnest debate of untested ideas enables each society to understand the

issues with better clarity and thereby to fashion the best solutions. Thus, Hong Kong can only benefit from this contest of ideas.

10. CONCLUSION

There has been no shortage of people who have asked me in the past eleven years — that is, ever since the Joint Declaration was signed — how I can be sure that the Chinese government will honor the treaty. At first, I could only say that there is much which is special in Hong Kong to China and it would be foolish to let this go up in smoke and, furthermore, China has an unblemished record for observing international agreements it has entered into. In eleven years, I have been able to put these views in clearer perspective and I have grown even more resolved in my conviction that China not only will honor the treaty but will draw strength from the SAR.

First, the Basic Law was enacted in 1990 after four years of drafting and extensive public consultation and debate. Like all constitutions, it will be as good as the people who apply and interpret it. However, it is a constitution which stands to benefit from the accumulated ideas of two hundred years of development of constitutional law and thinking around the world. I am confident that with an open-minded legal profession and judiciary, this is a constitution which will enable our institutions to grow and meet the challenges of the future.

Secondly, in eleven years of working contact with Chinese officials at all levels, I find great admiration for the legal and governmental institutions of Hong Kong, and among those responsible for Hong Kong affairs, a good understanding of Hong Kong.

Thirdly, with the rapid economic growth in China and the region, China itself is deeply conscious of the need for a legal system that can sustain economic growth. Hong Kong has been a useful exemplar in the process of building a legal system for a market economy and many of us have been involved in advising on legislation or regulation of one form or another. As a big country, China cannot react with great speed, but no one will deny that it has made great strides, when one takes account of the growing body of Chinese law and the flowering of private, independent lawyering.

The granting of the right of an accused to independent and confidential legal advice and representation upon arrest, the

adoption of the presumption of innocence, and the placing of the burden of proof on the prosecution in the new Criminal Procedure Law promulgated in 1996 for implementation on July 1, 1997, are yet other examples of the continuing development of the Chinese legal system. There was a fundamental revamping of the taxation system in 1994, and the rebuilding of the banking system to deal with a developing market economy is being actively pursued.

These reforms will need time to work out, but I am certain that any objective person would permit himself a degree of cautious optimism. He will say that this is a good beginning, which shows China's seriousness in building a sound legal system for the future. I, too, share this optimism for the future.