APPENDIX 1

THE CLOSURE AND SUBSEQUENT EVENTS

On Monday, 19 October 1987, following three successive days' decline on the New York stock market, which saw a 10.5% fall in the Dow Jones Industrial Average, the Hong Kong stock market fell by about 11.1% on a turnover of $4,176 million. In Japan, the Nikkei fell by 2.4%, while in London, the Financial Times 30 fell by 10.1%, in Australia, the All Ordinaries Index fell by 3.7% and in New York, the Dow Jones fell by 22.6%, its largest ever percentage one day fall.

2. The Hong Kong stock market, along with other world equity markets, had been on a strong uptrend for some time. Put into a world context, the comparative figures were as follows -

<table>
<thead>
<tr>
<th>Index</th>
<th>1987 Peak</th>
<th>Date</th>
<th>Level on that date in 1986</th>
<th>Percentage increase in 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Times 30</td>
<td>1,926</td>
<td>16 July</td>
<td>1,306</td>
<td>47%</td>
</tr>
<tr>
<td>Dow Jones</td>
<td>2,722</td>
<td>25 Aug</td>
<td>1,872</td>
<td>45%</td>
</tr>
<tr>
<td>Nikkei</td>
<td>26,646</td>
<td>14 Oct</td>
<td>17,318</td>
<td>54%</td>
</tr>
<tr>
<td>Hang Seng</td>
<td>3,950</td>
<td>1 Oct</td>
<td>2,090</td>
<td>89%</td>
</tr>
<tr>
<td>Australia All Ordinaries</td>
<td>2,306</td>
<td>21 Sept</td>
<td>1,211</td>
<td>90%</td>
</tr>
</tbody>
</table>

The Hang Seng Index (HSI) had moved from 2,540 on 2 January 1987 to an all time high of 3,950 on 1 October 1987, i.e. a rise of 1,410 or 55% in the space of nine months (1). Turnover had almost trebled during the period.

3. The HSI futures market recorded a similar strong uptrend during that period. From its launch in May 1986, when 31,070 lots were traded, turnover grew at an increasing pace so that by September 1987, 601,005 lots were traded, i.e. an increase of nearly 2,000% in 17 months.

(1) Base date for the HSI: 31 July 1964 at 100 points.
4. In the light of the reversals on the major overseas equity markets during the preceding week, the Hong Kong Futures Exchange (HKFE), prior to commencement of trading on 19 October 1987, imposed a spot month limit of 180 points up or down per half-day session and 150 points up or down per half-day session on the two longer months. At the same time, the clearing house, ICCH (Hong Kong) Ltd., made an intra-day margin call at midday on all members holding long positions - 49 in total - for one additional deposit of $8,000 per lot (2). The deposit was increased to $10,000 per lot at 3.00 p.m. the same day. Contracts for all three months traded limit down for the day.

5. When news of the record fall in New York reached Hong Kong in the early hours of 20 October 1987, the Chairman of the Stock Exchange of Hong Kong Ltd. (SEHK) informed the Financial Secretary of his intention to seek the Exchange Committee's agreement to suspend trading for the rest of the week. Despite doubts expressed by the Administration regarding the length of the intended closure, the Committee, at an emergency meeting held at 8.30 a.m. in the morning, decided to suspend trading for four days under its general power to administer affairs of the Exchange (Rule 203) and under the specific power to suspend all trading activities in the event of an emergency (Rules 204(11) and 572).

6. The SEHK Committee's decision to suspend trading for four days as publicly announced was based on the following: concerns regarding the possibility of panic selling, confusion and disorder in the market, the liquidity of members, the possibility of bank runs and the uncertainty caused by the settlement backlog (then estimated at over 250,000 deals, equivalent of a full week's trading).

7. Following the SEHK's decision to suspend trading for four days, the HKFE also decided on 20 October to suspend trading of HSI futures contracts for the same period. Later in the day (20 October 1987), the Chairman of the HKFE informed the Secretary for Monetary Affairs that, as a result of clients walking away from their commitments, futures brokers were having difficulties in margining contracts (3). The Chairman pointed out that

(2) The total amount of intra-day margin called was $192 million. This was fully met except for $7 million, of which $4 million was received the following day.

(3) Of the $382 million margins called, based on 19 October's limit down prices, $108 million (or 28%) remained outstanding at the day's close.
there were serious doubts about the ability of the Hong Kong Futures Guarantee Corporation (FGC), which had a capitalisation of $15 million and accumulated reserves of around $7.5 million, to meet its obligations.

8. The Hong Kong Unit Trust Association also indicated (on 20 October 1987) that many unit trusts had been left exposed by the decision to suspend trading on the two Exchanges and that redemption of units was likely to be suspended in the interim (4).

9. As the HKFE could not resume trading without some reinstatement of the guarantee, the Secretary for Monetary Affairs held a meeting in the morning of 21 October with the Chairman of the FGC and representatives of the major futures brokers to consider the matter. At the meeting, the brokers stressed the gravity of the situation and pointed out that, of the approximately 40,000 outstanding HSI futures contracts, a very large number of the short positions were held by arbitrageurs and hedgers, who were mainly overseas institutional clients. The arbitrageurs' and hedgers' short positions were held against physical stock holdings, estimated to be in the region of between $5 billion to $6 billion. The brokers added that, if the futures markets collapsed or if any attempt was made to "ring out" contracts at an arbitrary price, these people would be forced to liquidate their physical holdings. This would create a massive downward pressure on the market, cause major economic disruptions and serious damage to Hong Kong's reputation as an international financial centre.

10. To resolve the problem, the brokers proposed a $2 billion capital injection into the FGC: comprising $1 billion from the Government, $0.5 billion from the shareholders of the FGC and $0.5 billion from the major futures brokers. This would cover a 1,000 points' fall in the HSI. The proposal was, however, rejected by the Government as it believed that the FGC should be recapitalised by its shareholders and that the holders of short positions should reach a voluntary agreement not to dump stocks.

11. Later that afternoon (21 October 1987), the Chairman of the HKFE pressed the Government to agree to a ring out of outstanding HSI contracts on the basis of the last trading price at the close of the market on 19 October to prevent a collapse of the Exchange. This was again resisted by Government.

(4) In the event, all but two of the unit trusts companies suspended redemptions during that week.
12. Following meetings between the Financial Secretary and the various parties involved on the HKFE and having regard to the different views and the complexity of the issues involved, the Government on 22 October 1987 engaged Hambros Bank Ltd., a leading London merchant bank, to act as Government's adviser on the matter. The Hambros' team was led by the Deputy Chairman of the Bank and included the Chairman of the London International Financial Futures Exchange (LIFFE).

13. After a series of meetings with the various participants in the market and a detailed analysis of the options available to the Government, a support package was put together over the weekend of 24/25 October 1987. The package consisted of a $2 billion loan, attracting market-related interest rates, to the FGC. This comprised $0.5 billion from the FGC's seven shareholders (viz. ICCH, Chartered Capital Corporation Ltd., Credit Lyonnais interests, Chase Manhattan Overseas Banking Corporation Ltd., Barclays Bank PLC, Wing On Bank and Hongkong and Shanghai Bank); $0.5 billion from a number of brokers and members of the HKFE; and $1 billion from the Hong Kong Government's Exchange Fund. Repayment would be through a transaction levy on the HKFE, a special levy on the SEHK and from delayed payments by and recoveries from defaulting members.

14. Other elements of the package included a reorganisation of the top management of the HKFE (under which Mr Wilfrid Newton and Mr Phillip Thorpe were appointed Chairman and Executive Vice-chairman of the Exchange) and undertakings from arbitrageurs not to sell any stocks held against short futures contracts until 31 December 1987 (the expiry of the longest Hang Seng Index contract then in existence) unless they closed out an equivalent short position on the futures market. They also undertook not to sell any securities matched against November HSI contracts until 1 November 1987 (the day when the November contract became the spot contract) (5).

15. Both the stock and futures markets reopened at 11.00 a.m. on 26 October 1987. The stock market opened sharply lower and the HSI plunged 1,120 points to close at 2,242, a 33% fall. On the HSI futures markets, a temporary ruling was imposed banning all selling except for liquidation, and the deposit on the contract was raised from $10,000 to $25,000 per contract. Spot month trading plunged to 1,975 in after hours trading, a drop of 1,544 or 44% on the spot month.

(5) Subsequent returns provided by the arbitrageurs showed that these undertakings were honoured.
16. In the light of the record fall during the day and since many futures brokers with long positions were unlikely to be able to put up further margins, the Chairman of the FGC advised the Financial Secretary in the afternoon that, unless additional resources could be provided, the FGC would have no option but to cease writing guarantees, leading to the closure of the HKFE.

17. To enable the FGC to meet its obligations, arrangements were made that evening to provide an additional $2 billion support facility (6), comprising $1 billion from the Exchange Fund, and $1 billion from the Hongkong and Shanghai Bank, the Standard Chartered Bank and the Bank of China in equal parts. This further facility would have enabled the FGC to continue to operate even if the HSI had dropped to the 1,000 level.

18. Moreover, in response to a request from a number of listed companies, the Takeovers Committee announced on 26 October 1987 a one-month waiver of the trigger and creeper provisions of Rule 33 of the Hong Kong Code on Takeovers and Mergers, provided there was full disclosure and that the positions were unwound within 12 months.

19. Furthermore, in an effort to support the market, the banks in Hong Kong made two successive 1% cuts in the prime rate from 8.5% to 7.5% on 26 October and then to 6.5% on 27 October 1987.

20. On 28 October 1987, the SEHK announced the appointment of Mr Robert Fell as the Senior Chief Executive of the Exchange.

21. After discounting margin payments made by futures brokers and liquidation by the clearing house of some 27,000 net long positions out of an overall uncovered position of 37,000 plus contracts, a total of $1.795 billion was drawn down from the support facility to enable the FGC to meet its obligations.

22. On 16 November 1987, the Governor appointed the Securities Review Committee to review the constitution, management and operations of the two Exchanges and their regulators.

23. On 2 January 1988 Mr. Ronald Li, who had by then retired as Chairman of the SEHK but continued as a member of the Committee, was arrested by officers of the Independent Commission Against Corruption (ICAC) and charged, on 15 January, under the Prevention of Bribery

(6) This facility expired on 26 April 1988 without having been drawn down.

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Ordinance with unlawfully accepting an advantage, namely a beneficial interest in an allotment of shares in a construction company in relation to the approval of a new issue of shares. Mr. Li and six other members of the Committee, who had not been charged, agreed to distance themselves from the affairs of the Exchange. Thereafter the management of the Exchange was vested in a 14-member Management Committee.
APPENDIX 2

MEMBERSHIP OF THE SECURITIES REVIEW COMMITTEE

Mr Ian Hay DAVISON (Chairman)
Mr S L CHEN, CBE, JP
Mr LAU Wah-sum, JP
The Honourable Peter POON Wing-cheung, MBE, JP
Mr Charles SOO
Mr Philip TOSE
Mr Michael WU (Secretary)
APPENDIX 3

REPRESENTATIONS RECEIVED

The following is a list of bodies, companies and individuals who submitted representations in response to the Securities Review Committee's announcement on 23 November 1987 inviting submissions on all aspects of the Committee's work:

Bodies (including those which are the subject of the Committee's review)

The Association of The Institute of Chartered Secretaries & Administrators in Hong Kong

City Polytechnic of Hong Kong, Department of Business and Management

Commodities Trading Commission

The Hong Kong Association of Banks

The Hong Kong Capital Markets Association

HK Economic Research Centre

Hong Kong Futures Exchange Ltd.

The Hong Kong Futures Guarantee Corporation Limited

The Hong Kong General Chamber of Commerce

Hong Kong Society of Accountants

The Hong Kong Society of Security Analysts Limited

Hong Kong Stockbrokers Association Ltd.

Hong Kong Unit Trust Association

Hong Kong Venture Capital Association Limited

I.C.C.H. (Hong Kong) Limited

The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited

The Law Society of Hong Kong
Life Insurance Council of Hong Kong
Securities Commission
The Stock Exchange of Hong Kong Ltd.
University of Hong Kong, Department of Management Studies

Companies
A group of international securities firms
Arthur Andersen & Co.
Asian Oceanic Limited
Barclays Bank PLC
Barclays de Zoete Wedd Securities (Asia) Limited
Baring International Asset Administration Limited
Baring Securities (Hong Kong) Limited
Central Registration Hong Kong Limited
ChinTung Holdings Limited
Chuang's & Co.
Citibank
Citicorp International Limited
Coopers & Lybrand
County NatWest Investment Management Asia Limited
County NatWest Securities Asia Limited
Crosby Securities (HK) Limited
Deutsche Bank (Asia) Hong Kong Branch
East Asia Warburg Ltd.
F.P. Special Assets Limited
F.R. Zimmern Ltd.
Financial Engineering Corp. Ltd.

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G.T. Management (Asia) Limited
Gibson, Dunn & Crutcher
Griffiths Management Limited
Hambro Pacific Limited
Heath Fielding Insurance Broking Limited
Hoare Govett Asia Limited
The Hongkong and Shanghai Banking Corporation
Hsin Chong Holdings (H.K.) Ltd.
IBI Asia (Securities) Limited
Indosuez Asia Limited
James Capel (Far East) Limited
Jardine Fleming Investment Management Limited
Jardine Fleming Securities Limited
Kaiser Stock & Share Co.
Koo & Company
Merrill Lynch Hong Kong Securities Limited
Ming Fung Bullion Co., Ltd.
Morgan Grenfell (Hong Kong) Limited
Morgan Grenfell International Fund Management Limited
Morgan Stanley
Nomura International (Hong Kong) Ltd.
Nomura Research International Co., Ltd.
Poon & Cheung, Solicitors
Robert Fleming Securities Limited
SBCI Securities (Asia) Limited
S.G. Warburg Securities (Far East) Ltd.
Samuel Montagu & Co. Limited
Schroders Asia Limited
Search Financial Services Ltd.
Shearson Lehman Brothers Asia Holdings Inc.
Smith New Court Far East Ltd.
Societe Generale, Hong Kong Branch
Spicer and Oppenheim
Standard Chartered Asia Limited
Standard Chartered Bank
Sun Hung Kai & Co. Limited
Swire Pacific Ltd.
W.I. Carr (Far East) Limited
Wah Ying & Company
Winfull Laing & Cruickshank Securities Ltd.
Wocom Securities Limited
The Wyatt Company (H.K.) Limited
Yamaichi International (H.K.) Ltd.

Individuals
CHAN, Peter P.F.
CHOI Chin Shan
CHOW, Peter K.N.
CHOU Wai Man
Farmer, Peter
FONG, Henry Yun Wah, MBE, JP
Gallie, R.T.
HO Hok Lin
HO Lok Sang
Jordan, D.J.
LAM, Keith H.K., JP
LAW, Passe Pak Hong
Mclean, John
Phenix, Paul
Phillips, Peter F.
Pirie, Nicholas
POON H.K.
SHUM, Lina Sui King
Sulke, W.M., OBE, JP
Thorpe, Phillip
TO Hoi Hung
Willoughby, Peter G., JP
WONG Wai Hang
WONG Wai Sun
WONG Yue Tak
YUNG Yau

Government Departments
Commissioner of Banking
Commissioner for Securities and Commodities Trading
Registrar General
Secretary for Monetary Affairs
APPENDIX 4

OVERSEAS INSTITUTIONS VISITED BY
THE SECURITIES REVIEW COMMITTEE

UNITED KINGDOM

Bank of England

International Stock Exchange of the United Kingdom and
the Republic of Ireland

The Securities and Investments Board

London International Financial Futures Exchange

The Securities Association

Association of Futures Brokers and Dealers

International Commodities Clearing House

Warburg Securities

Postel

Institute of Economic Affairs

USA

Chicago

Chicago Mercantile Exchange

Chicago Board of Trade

Chicago Board of Trade Clearing Corporation

National Futures Association

Midwest Clearing Corporation

Midwest Securities Trust Company

Washington

Securities and Exchange Commission

Commodities Futures Trading Commission

General Accounting Office
New York
New York Stock Exchange
New York Futures Exchange
Federal Reserve Bank of New York
National Securities Clearing Corporation
Depository Trust Corporation

JAPAN
Securities Bureau, Ministry of Finance
Tokyo Stock Exchange
Nomura Securities Company Limited
Maruso Securities Co. Ltd.

SINGAPORE
Singapore International Monetary Exchange Ltd.
The Stock Exchange of Singapore
Citicorp Scrimgeour Vickers
Summit Securities
N.M. Rothschild & Sons
Monetary Authority of Singapore

FRANCE
M.A.T.I.F.

AUSTRALIA
Sydney Futures Exchange
Australian Stock Exchange (Sydney) Limited
Australian Stock Exchange (Melbourne) Limited
National Companies and Securities Commission
APPENDIX 5

OVERSEAS ORGANISATIONS NOT VISITED BY THE COMMITTEE WHICH HAVE ASSISTED ITS WORK

Canadian Depository for Securities Limited
Stockholm Stock Exchange
Australian Stock Exchange
Arthur Andersen & Co.
Hong Kong Government Office, Washington
British Embassy, Tokyo
Euroclear
Cedel
Compagnie des Agents de Change, Paris
APPENDIX 6

TECHNICAL DISCUSSIONS

The following firms, associations and individuals were invited to attend technical discussions with the Securities Review Committee:

Members of the Hong Kong Stockbrokers Association
(three group discussions attended by individual brokers, corporate brokers and brokers who also trade on the Hong Kong Futures Exchange)

Arthur Andersen & Co.
Central Registration Hong Kong Limited
Citicorp International Limited
Coopers & Lybrand
G.T. Management (Asia) Limited
Gibson, Dunn & Crutcher
Heath Fielding Insurance Broking Limited
Hongkong and Shanghai Banking Corporation
Hong Kong Society of Security Analysts Limited
Jardine Fleming (Securities) Limited
Law Society of Hong Kong
Mr Keith H.K. LAM, JP
Mr Derek Murphy
Mr Paul Phenix
Mr Peter F Phillips
The following bodies attended formal meetings with the Securities Review Committee:

The Stock Exchange of Hong Kong Limited
The Hong Kong Futures Exchange Limited
The Hong Kong Futures Guarantee Corporation Limited
I.C.C.H. (Hong Kong) Limited
Securities Commission
Commodities Trading Commission
Secretary for Monetary Affairs
Commissioner for Securities and Commodities Trading
Hong Kong Association of Banks
Hong Kong Unit Trust Association
Hong Kong Stockbrokers Association
Hong Kong Society of Accountants
## COMPARISON OF WORLD'S MAJOR EQUITY MARKETS

(as at end December 1987)

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Number of listed companies</th>
<th>Total market capitalisation</th>
<th>Total turnover value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
<td>Foreign</td>
<td>Total</td>
</tr>
<tr>
<td>Tokyo</td>
<td>1532</td>
<td>88</td>
<td>1620</td>
</tr>
<tr>
<td>New York</td>
<td>1577</td>
<td>70</td>
<td>1647</td>
</tr>
<tr>
<td>London</td>
<td>2061</td>
<td>597</td>
<td>2658</td>
</tr>
<tr>
<td>Germany(1)</td>
<td>507</td>
<td>212</td>
<td>719</td>
</tr>
<tr>
<td>Toronto</td>
<td>1147</td>
<td>61</td>
<td>1208</td>
</tr>
<tr>
<td>Paris</td>
<td>481</td>
<td>202</td>
<td>683</td>
</tr>
<tr>
<td>Australia(1)</td>
<td>1445</td>
<td>40</td>
<td>1485</td>
</tr>
<tr>
<td>Zurich</td>
<td>166</td>
<td>213</td>
<td>379</td>
</tr>
<tr>
<td>Italy(1)</td>
<td>204</td>
<td>0</td>
<td>204</td>
</tr>
<tr>
<td>Amsterdam</td>
<td>226</td>
<td>227</td>
<td>453</td>
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<tr>
<td>American</td>
<td>815</td>
<td>51</td>
<td>866</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>264</td>
<td>12</td>
<td>276</td>
</tr>
<tr>
<td>Korea</td>
<td>389</td>
<td>0</td>
<td>389</td>
</tr>
<tr>
<td>Singapore</td>
<td>127</td>
<td>194</td>
<td>321</td>
</tr>
</tbody>
</table>

Source: FIBV International Statistics

(1) These figures include a number of exchanges.
APPENDIX 9

VIEWS OF INTERNATIONAL INVESTORS ON
THE STOCK EXCHANGE OF HONG KONG

Summary of Burson-Marsteller’s Study
carried out for the SEHK

Introduction

Following the market crash in October, the Stock
Exchange of Hong Kong (SEHK) commissioned Burson-
Marsteller, a corporate, financial and marketing
communications firm, to conduct a study on the then current
attitudes of international investors towards Hong Kong as a
financial and securities centre. It should be emphasised
that the survey was taken soon after the October collapse
when opinion in all markets was nervously uncertain and
when, in addition to the market collapse, various
management weaknesses in Hong Kong had become apparent.

Objectives and methodology

2. The objectives of the study were: -

(a) to assess the overall perception of Hong
Kong as an international and regional
financial centre after the global equity
crash in October 1987;

(b) to measure the level of damage incurred
internationally by Hong Kong's extreme
share price fall, and its stock exchange
closure;

(c) to determine the level of knowledge of,
and reactions to, specific actions taken
by the Hong Kong Stock Exchange,
Government, and media, following the
crash; and

(d) to determine the overall level of
confidence in investing in Hong Kong and
to solicit recommendations on improving
that confidence.

3. A total of 31 members of the investment community
in London, New York, Tokyo, Sydney and Hong Kong were
interviewed during December 1987. Respondents included
institutional portfolio fund managers, equity fund
managers, department heads in retail brokerages and senior
institutional analysts. Due to the small sample size, the results are indicative rather than predictive. They, however, provide some illustrative comments on international investors' perception at that time of the Hong Kong stock market.

**Main findings**

4. Hong Kong was generally perceived as being a "second tier" capital market due to its small capitalisation and limited domestic market relative to major markets in London, New York and Tokyo, and thus "moderately important" on a global basis. It was often compared to the European markets in relative importance. Hong Kong's two greatest strengths were its regional role and its proximity to China.

5. However, it was seen as playing a leading role in the region compared to other markets with the majority of respondents, especially those from Hong Kong, Sydney and London (in that order), touting its strengths. Factors in Hong Kong's favour were the economy's growth prospects, the highly deregulated nature of the market, market liquidity and accessibility. It was also considered far easier to run a regional operation out of Hong Kong.

6. On the downside, some respondents, primarily from New York and Tokyo, characterized the market as relatively undeveloped, without the range of stocks of other leading markets and dominated by property.

7. Before the global equities crash, respondents averaged one per cent of their funds invested in the Hong Kong market though many had moved above this, out of line with the relative capitalisation of the market. It was felt that as a smaller market, Hong Kong was likely to be one of the first to be cut out of an investment portfolio during a global crash.

8. Most respondents agreed that the global stock market situation would dictate policies regarding buying Hong Kong equities. It was felt that Hong Kong would still be a key Asian market, though some noted that investors, who had been hurt by the closure, such as the Australians, would need to be convinced before investing in Hong Kong again. Hong Kong-based investment managers were the exception, with surprisingly bullish views on current values in Hong Kong.

9. Locally and internationally, both the stock market and the Stock Exchange were described as volatile and speculative. More than 50% of all respondents in Hong Kong, London, Tokyo and New York chose one of these two
words when characterising the institutions. Australian respondents were particularly negative in their characterisations of the Stock Exchange, calling it "dishonest", "corrupt", "unstable", "shady", "shambles", "unrepresentative", "opportunistic" and "a joke". Australia suffered a relatively larger crash than Hong Kong and Australian brokers blamed some of the severity of their crash on Sydney being open while Hong Kong was closed. In addition, an Australian journalist made world television headlines in an encounter with the then Chairman, Mr Ronald Li.

10. Hong Kong respondents pointed to lack of liquidity, leading to increased volatility, as the primary reason for the severity of Hong Kong's equity crash. International markets, especially London, cited the speculative nature of the market and the high proportion of foreign investment as the key contributing factors: "Hong Kong had been a major beneficiary of global investment and as a result was severely hurt as overseas investors closed their positions to cover domestic losses".

11. Most respondents were well versed in the arguments for and against the closure and the majority were sharply against it, saying it had adversely affected the Exchange's international reputation and reduced confidence. Those most understanding of the closure were the US respondents who pointed out that several other markets were 'technically closed' and that there were special circumstances in Hong Kong. The least understanding were the Japanese.

12. However, respondents were unanimous in stating that the closure had damaged the Exchange's international reputation, certainly in the short-term. It was agreed that, if reforms were carried out in Hong Kong, when money can again be made in the market overseas investors will return. Japanese respondents were particularly harsh, saying the Stock Exchange of Hong Kong had severely damaged its most important asset - its image as a free market.

13. The appointments of Mr Robert Fell as Chief Executive of the Exchange, Mr Ian Hay Davison to head the Securities Review Committee, and Coopers & Lybrand (1) were known to varying degrees and almost universally welcomed. The exception was among Japanese respondents who had little or no knowledge of these developments. However, most

(1) Messrs Coopers & Lybrand, Accountants, were appointed by the SEHK Management Committee to review the surveillance arrangement at the SEHK.
respondents were unwilling to prejudge the issue and said
they waited with interest to see what measures were
introduced to reform the Exchange.

14. The Hong Kong Government was blamed for "not doing
enough before the crash and too much after" by respondents
in Hong Kong, London and Sydney. Interestingly, Japanese
respondents heartily applauded the Government's bail-out
efforts. Hong Kong respondents complained the Government
did not know enough about how markets worked to act
correctly.

15. The alleged conflict between international and
local brokers was considered to have been blown out of
proportion, "almost dangerously so", by analysts and fund
managers in Hong Kong. However respondents in London and
Sydney did not agree; they felt it was a serious issue and
should be addressed, although few solutions were offered.

16. Media coverage of the Stock Exchange was rated
sensational but fair. Respondents in London and Tokyo said
they relied more on their brokers for information than on
the media.

17. Respondents were almost unanimous in their opinion
that confidence had been lost in the Exchange, and this was
primarily due to the closure. A Hong Kong fund manager
summed up many responses, "Actions speak louder than
words. If what comes out of this is a better system that
works efficiently and is seen by the international
community to have high standards, then it will bring back
confidence".

18. Respondents in both London and New York felt that
the confidence issue was much broader and reflected a loss
of investor confidence worldwide. Until the major markets
recover there will not be a return of foreign capital to
Hong Kong.

19. All respondents agreed that confidence would not
and could not be restored overnight.
APPENDIX 10

DEVELOPMENT OF THE SECURITIES INDUSTRY IN HONG KONG

Background

Trading in equities has a long history in Hong Kong. The first stock exchange was established in 1891. This was the Association of Stockbrokers in Hong Kong which changed its name to the Hong Kong Stock Exchange in 1914. A second exchange, the Hong Kong Stockbrokers Association, was started in 1921 to give wider membership. These two exchanges were merged into the Hong Kong Stock Exchange in 1947.

2. For decades, the Hong Kong Stock Exchange played only a minor role in the Hong Kong capital markets, bank lending being the main source of finance for corporations. Up to 1962, there were only 65 companies listed on the exchange.

3. In the five year period from 1960 to 1965, the Hong Kong Stock Exchange experienced its first period of rapid expansion. Annual average turnover increased from $200 million before 1960 to an average of $852 million during the five year span. This increased activity was due partly to the general prosperity of Hong Kong and partly to the quality of shares that appeared in the market (1). The shares of these companies were priced at fixed levels which virtually ensured successful flotations. Many small investors made quick and easy profits during this period which helped shape the psychological attitude toward securities investment in the 1971-1973 boom. Development of the securities industry after the period was, however, hampered by the banking crisis in 1965 and the disturbances of 1967. Annual turnover for the period dropped to under $350 million.

4. Despite the growth in the early part of the 1960's, the stock market remained peripheral to the Hong Kong capital market. In line with the non-interventionist policy of the Government, there was a virtually complete absence of regulation of the securities industry. This was not really surprising as the market was basically sound. There were few listed companies and most were

(1) Among the companies listed in the period 1961-1965 were the Hong Kong & China Gas Company Limited (1960), The Kowloon Motor Bus Co. (1933) Ltd. (1961) and the China Motor Bus Company, Ltd. (1962).
well-established enterprises with underlying assets which justified prices. There was, therefore, no urgent need for government supervision. Moreover, following the banking crisis during the latter part of the 1960's, the Government was engaged in the regulation of the banking industry.

5. The modern development of the securities industry in Hong Kong in terms of market development and statutory regulation took place in the last two decades.

6. The opening of the Far East Stock Exchange in December 1969 revolutionised the local stock market scene. The new exchange broke with the London-style business practices of the Hong Kong Stock Exchange and established rules suited to the Chinese business community. Trading was in Cantonese. Many local businessmen became stockbrokers with no qualifications other than an investment of $500,000, the price of a seat on the Exchange. Listings were numerous and fairly easy to obtain. Stocks were priced at levels attractive to the ordinary investor and were traded in small board lots which made stock investment easy for the man in the street.

7. The Far East Stock Exchange very soon surpassed the Hong Kong Stock Exchange in terms of trading volume. Its success encouraged the establishment of further exchanges. The Kam Ngan Stock Exchange was opened in March 1971, its membership was connected with the long established Gold and Silver Trading Society, and the Kowloon Stock Exchange commenced trading in January 1972. By early 1973, the total number of broker members in Hong Kong exceeded 1,000. Plans were afoot to start a number of additional Exchanges.

8. Local companies, irrespective of their underlying assets or trading record, took advantage of the strong market and investor sentiment to go public. There was a proliferation of listed companies and more were waiting in the queue (2).

9. In an attempt to control the market, the Financial Secretary, announced in January 1973, the drafting of a new bill to regulate the securities industry. In the same month, a Securities Advisory Council was established and a Commissioner for Securities was appointed to pave the way for the enforcement of statutory provisions to be enacted. In response to news about the formation of a fifth

(2) During 1973 alone, there were 53 public offers and 48 placements of shares on the exchanges, bringing the total number of listed companies to 296 at the end of 1973.
exchange, emergency legislation - the Stock Exchange Control Ordinance - was enacted in February 1973 (3) to prohibit the creation of further exchanges.

10. Meanwhile, the bull market continued. Total turnover increased three-fold from $14,806 million in 1971 to $42,908 million in 1972 (4). The Hang Seng Index reached a record high of 1774.96 on 9 March 1973. There were relatively few institutional investors in the market and mutual funds were uncommon. Participants were mainly individual local investors, from middle class entrepreneurs to housewives and domestic maids. All were taking their life savings from banks and pouring them into the stock market.

11. The bull market was stopped dead in its track in March 1973. Prices fell as fast as they had risen. Within a matter of months, the Hang Seng Index fell from its all time high of 1775 points on 9 March 1973 to 437 points in December 1973 and reached a low of 150 points the following year. The crash was generally attributed to the psychological impact on small investors of such factors as concerns by analysts about the over-valuation of shares and the appearance of forged share certificates.

12. Prompted by the frenzied market activities the Securities Ordinance and the Protection of Investors Ordinance were enacted on 13 February 1974. Both were based on the recommendations of the Companies Law Revision Committee. They established, for the first time, a regulatory framework for the securities industry in Hong Kong. The Securities Ordinance also formally established the Securities Commission and the Commissioner for Securities.

13. The development of the regulatory framework (5) and increased prudential supervision of the securities

(3) The Stock Exchange Control Ordinance was repealed upon the enactment of the Securities Ordinance in February 1974.

(4) Similar growth was witnessed later during the periods 1977/78, 1979/80 and 1986/87 in each of which turnover was more than treble that of the preceding year.

(5) Regulatory activities in this period included the establishment of the Stock Exchanges Compensation Fund in August 1974, the Code on Takeovers and Mergers for Hong Kong approved by the Securities Commission in August 1975, the promulgation of the Securities (Stock Exchange Listing) Rules in 1976, the establishment of the Insider Trading Tribunal in 1977.
industry prompted the need for a joint body to represent the brokerage profession. The Hong Kong Federation of Stock Exchanges was formed in July 1974 and, up to its dissolution in April 1986, remained the consultative body representing the interests of the broking community.

14. In view of the difficulty of regulating four exchanges and the absence of unified rules and procedures essential to market expansion, unification of the four stock exchanges was first suggested in 1975 with the full support of the Securities Commission. Early in 1976, the Commissioner for Securities approached the exchanges with the idea; they refused to consider the matter.

15. In 1977, motivated by the continued decline of the stock market, the exchanges warmed to the idea of unification and a working party was set up under the chairmanship of the Commissioner for Securities. However, little progress was made in the two years that followed. When it became evident that unification on a voluntary basis was unattainable, the Government introduced legislation to bring it about. The Stock Exchanges Unification Ordinance, which provides for the establishment of a Unified Exchange, was enacted on 7 August 1980.

16. Under the Ordinance, the Stock Exchange of Hong Kong Limited, which was incorporated on 7 July 1980, was given an exclusive right to operate a stock market in Hong Kong, from a date to be appointed by the Financial Secretary. Invitations were then extended to all members of the four exchanges to apply for shares in the Company. The shares carried with them membership of the Unified Exchange. The move had a significant impact on the membership structure of the Unified Exchange.

17. The period leading towards unification also saw the introduction of international securities institutions in the Hong Kong market. Prior to 1979, overseas institutions were not allowed to trade directly on the Exchange. They could only trade through an existing full member. In 1979, the Far East Exchange, in an unprecedented move, admitted a representative of a Canadian stockbroker as a full member. Full membership soon followed for overseas members in the Hong Kong and Kam Ngan Stock Exchanges. Membership had, however, to be in the name of a sole trader. In practice, however, these institutions held seats on the Exchanges through the use of nominee members controlled by deeds of trust. This approach was carried over into the membership of the Unified Exchange. The Stock Exchanges Unification Ordinance disqualified banks, DTCs, corporations and firms from membership.
18. In 1982, to meet the changing needs of the securities industry, the Committee of the Unified Exchange proposed to remove the ban against corporations, local or international, so as to encourage participation by substantial wholesale dealers. This proposal led to amendments to the Stock Exchanges Unification Ordinance enacted in August 1985 which permitted corporations to become members of the Unified Exchange and removed the disqualifications for practising solicitors, accountants and directors or employees of banks and DTCs.

19. The period following the opening of the Unified Exchange on 2 April 1986 witnessed a vigorous bull market. The Hong Kong stock market also began to assume the characteristics of an international exchange.

20. Following the global bull market and supported by strong local economic performance, the stock market surged. The Hang Seng Index reached an all time high of 3949.73 on 1 October 1987 and the highest daily turnover record was set the following day at a figure of HK$5,407.55 million (US$693.28 million). In effect, share prices increased by 89% in the 12-month period between 1 October 1986 and 1 October 1987, while turnover almost trebled over the same period. The advance was fuelled by substantial corporate activity, including encouraging company results, new issues, takeovers and capital restructurings. From end-April 1986 to end-September 1987, the number of listed companies increased from 251 to 272. There were 20 reconstructions of companies or re-activations of shell companies during the same period.

21. The period also saw a significant increase in overseas investment in the local market. Although many of the international brokers are indirectly affiliated with American parents the preponderance have their immediate head offices in London. Although no statistics are available on the amount of trading attributed to international investors, the contribution of corporate members is a reasonable reflection of their involvement. It is widely accepted that corporate members, many of whom are part of the international brokerage community, account for a very high proportion of the international business conducted on the Exchange. The number of corporate members on the Unified Exchange grew from eight in April 1986 to 85 at the end of December 1987. Their contribution to the trading volume, in value terms, rose from 23.17% in April 1986 to an average of 50% throughout 1987 and touched a peak of 57% in April 1987.
22. Market sentiments remained bullish immediately prior to the market collapse. Securities analysts were convinced that the bull market, supported by strong fundamentals, would run further (6). In the week preceding 19 October 1987, the Hang Seng Index fell only 99 points or 2.6% in response to an almost 10.5% drop in Dow Jones Industrial Index over three days' trading.

23. On Monday, 19 October 1987, the worldwide "free fall" began. In Hong Kong, the Hang Seng Index fell 420.81 points to 3,362.39, a drop of 11.1%. The market closed and the events leading to this report, described in Chapter I, began.

(6) In its October Hong Kong newsletter, Jardine Fleming (Securities) Limited stated that "notwithstanding the recent sharp runup in share prices, the pillars on which this bull market is founded are intact .... the market is still trading at an attractive level given the growth rate of corporate profits and the rating of other markets worldwide."
**APPENDIX II**

THE STOCK EXCHANGE OF HONG KONG  
MARKET CAPITALIZATION BY SECTORS AT END 1987

<table>
<thead>
<tr>
<th>Sector</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>16.30</td>
</tr>
<tr>
<td>Utilities</td>
<td>17.47</td>
</tr>
<tr>
<td>Properties</td>
<td>26.11</td>
</tr>
<tr>
<td>Consolidated Enterprises</td>
<td>29.61</td>
</tr>
<tr>
<td>Industrials</td>
<td>6.38</td>
</tr>
<tr>
<td>Hotels</td>
<td>4.08</td>
</tr>
<tr>
<td>Others</td>
<td>0.05</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

Source: The Stock Exchange of Hong Kong Limited  
Fact Book 1987
APPENDIX 12

THE STOCK EXCHANGE OF HONG KONG LIMITED
INCOME FOR THE YEAR ENDING 30 JUNE 1987

<table>
<thead>
<tr>
<th>Source</th>
<th>Income (HK $'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction Levy</td>
<td>122,348</td>
</tr>
<tr>
<td>Listing Fees</td>
<td>24,442</td>
</tr>
<tr>
<td>Audio Broadcast and Sales of Teletext Terminals</td>
<td>8,874</td>
</tr>
<tr>
<td>Application Fees and Members Subscription</td>
<td>6,078</td>
</tr>
<tr>
<td>Interest Income</td>
<td>2,176</td>
</tr>
<tr>
<td>Advertising and Sales of Publications</td>
<td>1,634</td>
</tr>
<tr>
<td>Ancillary Income</td>
<td>360</td>
</tr>
</tbody>
</table>

$165,912

Source: The Stock Exchange of Hong Kong Limited Annual Report 1987
APPENDIX 13

THE STOCK EXCHANGE OF HONG KONG
NUMBERS OF INDIVIDUAL AND CORPORATE MEMBERS

(April 1986 to April 1988)

<table>
<thead>
<tr>
<th>Date</th>
<th>Individual Members</th>
<th>Corporate Members</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd April 1986*</td>
<td>892</td>
<td>8</td>
<td>900</td>
</tr>
<tr>
<td>June 1986</td>
<td>860</td>
<td>22</td>
<td>882</td>
</tr>
<tr>
<td>September 1986</td>
<td>832</td>
<td>34</td>
<td>866</td>
</tr>
<tr>
<td>December 1986</td>
<td>788</td>
<td>51</td>
<td>839</td>
</tr>
<tr>
<td>March 1987</td>
<td>760</td>
<td>58</td>
<td>818</td>
</tr>
<tr>
<td>June 1987</td>
<td>736</td>
<td>68</td>
<td>804</td>
</tr>
<tr>
<td>September 1987</td>
<td>714</td>
<td>75</td>
<td>789</td>
</tr>
<tr>
<td>December 1987</td>
<td>688</td>
<td>85</td>
<td>773</td>
</tr>
<tr>
<td>March 1988</td>
<td>669</td>
<td>96</td>
<td>765</td>
</tr>
<tr>
<td>April 1988</td>
<td>664</td>
<td>98</td>
<td>762</td>
</tr>
</tbody>
</table>

* Unified Exchange commenced trading

Source: The Stock Exchange of Hong Kong Limited
APPENDIX 14

RELATIVE CONTRIBUTION OF
INDIVIDUAL AND CORPORATE MEMBERS TO
STOCK MARKET TURNOVER BY VALUE

(April 1986 to April 1988)

<table>
<thead>
<tr>
<th>Month</th>
<th>Total Turnover ($ million)</th>
<th>Contribution by Individual Members ($ million)</th>
<th>Contribution by Corporate Members ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apr</td>
<td>9,350.33</td>
<td>7,183.86 (76.83)</td>
<td>2,166.47 (23.17)</td>
</tr>
<tr>
<td>May</td>
<td>8,033.33</td>
<td>5,699.65 (70.95)</td>
<td>2,333.68 (29.05)</td>
</tr>
<tr>
<td>Jun</td>
<td>4,978.36</td>
<td>3,059.20 (61.45)</td>
<td>1,919.16 (38.55)</td>
</tr>
<tr>
<td>Jul</td>
<td>8,486.57</td>
<td>4,913.72 (57.90)</td>
<td>3,572.85 (42.10)</td>
</tr>
<tr>
<td>Aug</td>
<td>9,836.58</td>
<td>5,648.16 (57.42)</td>
<td>4,188.42 (42.58)</td>
</tr>
<tr>
<td>Sep</td>
<td>11,432.84</td>
<td>6,937.45 (60.68)</td>
<td>4,495.39 (39.32)</td>
</tr>
<tr>
<td>Oct</td>
<td>23,125.18</td>
<td>10,732.40 (46.41)</td>
<td>12,392.78 (53.59)</td>
</tr>
<tr>
<td>Nov</td>
<td>14,577.09</td>
<td>7,392.04 (50.71)</td>
<td>7,185.05 (49.29)</td>
</tr>
<tr>
<td>Dec</td>
<td>19,188.88</td>
<td>9,644.33 (50.26)</td>
<td>9,544.55 (49.74)</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan</td>
<td>21,691.02</td>
<td>11,372.60 (52.43)</td>
<td>10,318.42 (47.57)</td>
</tr>
<tr>
<td>Feb</td>
<td>28,260.26</td>
<td>14,568.16 (51.55)</td>
<td>13,692.10 (48.45)</td>
</tr>
<tr>
<td>Mar</td>
<td>23,772.52</td>
<td>11,912.41 (50.11)</td>
<td>11,860.11 (49.89)</td>
</tr>
<tr>
<td>Apr</td>
<td>14,004.69</td>
<td>5,711.11 (40.78)</td>
<td>8,293.58 (59.22)</td>
</tr>
<tr>
<td>May</td>
<td>21,617.59</td>
<td>9,286.92 (42.96)</td>
<td>12,330.67 (57.04)</td>
</tr>
<tr>
<td>Jun</td>
<td>25,993.05</td>
<td>11,938.61 (45.93)</td>
<td>14,054.44 (54.07)</td>
</tr>
<tr>
<td>Jul</td>
<td>34,978.71</td>
<td>16,733.81 (47.84)</td>
<td>18,244.90 (52.16)</td>
</tr>
</tbody>
</table>

380
<table>
<thead>
<tr>
<th>Month</th>
<th>Total Turnover ($ million)</th>
<th>Contribution by Individual Members ($ million)</th>
<th>Contribution by Corporate Members ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug</td>
<td>40,557.29</td>
<td>18,291.34 (45.10)</td>
<td>22,265.95 (54.90)</td>
</tr>
<tr>
<td>Sep</td>
<td>60,372.23</td>
<td>29,057.15 (48.13)</td>
<td>31,315.08 (51.87)</td>
</tr>
<tr>
<td>Oct</td>
<td>61,887.50</td>
<td>28,957.16 (46.79)</td>
<td>32,930.34 (53.21)</td>
</tr>
<tr>
<td>Nov</td>
<td>22,320.90</td>
<td>10,638.14 (47.66)</td>
<td>11,682.76 (52.34)</td>
</tr>
<tr>
<td>Dec</td>
<td>15,950.70</td>
<td>7,898.79 (49.52)</td>
<td>8,051.91 (50.48)</td>
</tr>
<tr>
<td>1988</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan</td>
<td>16,217.14</td>
<td>7,615.57 (46.96)</td>
<td>8,601.57 (53.04)</td>
</tr>
<tr>
<td>Feb</td>
<td>9,302.63</td>
<td>3,662.45 (39.37)</td>
<td>5,640.18 (60.63)</td>
</tr>
<tr>
<td>Mar</td>
<td>23,940.19</td>
<td>10,239.22 (42.77)</td>
<td>13,700.97 (57.23)</td>
</tr>
<tr>
<td>Apr</td>
<td>18,758.08</td>
<td>8,026.58 (42.79)</td>
<td>10,731.50 (57.21)</td>
</tr>
<tr>
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<tr>
<td></td>
<td>548,633.66</td>
<td>267,128.83 (48.69)</td>
<td>281,512.83 (51.31)</td>
</tr>
</tbody>
</table>

Figures in ( ) equal % of total market turnover

Source: The Stock Exchange of Hong Kong Limited
APPENDIX 15

SUB-COMMITTEES OF THE STOCK EXCHANGE OF HONG KONG

(1) Executive
(2) Membership
(3) Disciplinary
(4) Financial Investigation
(5) Listing
(6) Floor Trading
(7) Technical Services
(8) Central Clearing
(9) Rules
(10) Finance
(11) Training
(12) Public Relations
(13) Publications
(14) Fidelity Fund

Source: Rules of the Exchange
The Stock Exchange of Hong Kong Limited
APPENDIX 16

RULE 226 OF THE STOCK EXCHANGE PROVIDING FOR SPECIFIC POWERS OF THE CHIEF EXECUTIVE

Without prejudice to Rule 225 above and any other provisions in these Rules expressly conferring power upon the Chief Executive, the Chief Executive shall have such powers as the Committee or any Sub-Committee may confer upon him including, in particular, the following powers:

(1) to supervise the trading activities at the trading hall of the Exchange and to take all necessary steps to maintain orderly and efficient trading, in accordance with the Rules of the Exchange; and to suspend trading in any issue of securities or by any Member in the manner as provided in these Rules or as directed or authorized by the Committee or any Sub-Committee;

(2) to be responsible for the employment of staff and officers of the Exchange;

(3) to report periodically to the Committee on all matters concerning the Exchange or on such occasions as may be expedient;

(4) to scrutinize and manage all matters relating to listing, membership including applications for membership;

(5) to exercise such disciplinary measures over the Members or their Authorized Clerks, Sales Representatives and Dealing Directors in any manner as herein after provided in these Rules in order to ensure compliance with the Securities Ordinance, the Unification Ordinance, the Articles and these Rules;

(6) to approve the appointment of any Authorized Clerk, Sales Representative or Dealing Director or to expunge the name of any Authorized Clerk, Sales Representative or Dealing Director from the Register of Authorized Clerks, Sales Representatives or Dealing Directors;
(7) to ensure good order and behaviour in the trading hall of the Exchange and for this purpose, to refuse entry to any person and to remove any person from the trading hall;

(8) to attend all meetings of the Sub-Committees; and

(9) to release at his absolute discretion information as to any Member's financial position or otherwise to the Commission or the Commissioner when so requested by any of them.

Source: Rules of the Exchange
The Stock Exchange of Hong Kong Limited
APPENDIX 17

SUMMARY OF THE MANAGEMENT PROPOSALS
OF THE STOCK EXCHANGE OF HONG KONG
1988

The Exchange's management proposals cover the following five main areas.

Organisational improvements

2. The management structure will broadly be divided into seven Divisions, i.e. Listing, Operational, Secretariat, Finance, Compliance, Management and Research and Publication overseeing 18 Departments. While the Council will continue to be responsible for policy, the day-to-day operations will be in the hands of the executive staff who will work to a network of sub-committees with clearly delegated authority. The sub-committees will be responsible for reporting to the Council.

3. The staff will work to a Chief Executive who will be responsible for formulating policy proposals for consideration by the Council. Within the policies and budget approved by the Council, he will have the authority to take the necessary action to ensure efficient management and administration of the Exchange. He will be the principal representative of the Exchange both locally and internationally.

4. The Chief Executive will be supported by a Deputy Chief Executive. There will be a tier of senior executives at Divisional level supported by managers at the Departmental level. The Division Heads will supervise the Department Heads to ensure that all operations are carried out efficiently. They will also act as a buffer between operations and decision making to ensure that action appropriate to the Exchange's strategy is carried out.

Reforms on listing

5. Following a review of the Exchange's listing rules and procedures by experts from the International Stock Exchange in London, changes have already been introduced in the procedures(1). New accommodation has been acquired for the Listing Division and staff recruitment is under way.

(1) See Appendix 18.
6. In addition to an Office Manager responsible for Personnel, Property and Accounts who will work directly to the division head, the Division will have the following three operational Departments:

(a) New Issues;
(b) Listed Securities Administration; and
(c) Information.

7. The Head of Listings will be responsible for both external liaison (Registrar General, Society of Accountants, Commissioner for Securities etc); and internal liaison (Chief Executive's Management Committee, Listing Committee etc). His functions will include recruitment, training and management, maintaining and developing listing standards, general policy matters, reviewing market practices etc.

(a) New Issues Department

8. The New Issues Department, will have the following duties:

(a) listing policy and rules;
(b) applications for listing;
(c) new issue document reading; and
(d) serving and liaison with the Listing Committee.

9. The Department will be small, about 11 in number including three examining officers supported by two document readers and legal accountancy advisers (who will also be available to advise the other Departments).

(b) Listed Securities Administration Department

10. This Department, which is likely to be the largest, is essentially the market surveillance area. It will:

(a) monitor compliance with the Listing Agreement
    . company announcements
company results
capital expansions and re-organisations
take-overs and mergers

(b) monitor special situations
peculiar price movements
unauthorised statements or press and analysts' comments
market rumours

(c) order trading suspensions.

11. It will also liaise with the firm surveillance area and the Information Department regarding company announcements and sponsoring brokers.

12. The Chief Executive envisages nine monitoring groups, each consisting of an examining officer and a document reader. Each group would be responsible for a number of related securities, e.g. Hang Seng Index components, financials, utilities, properties, conglomerates etc.

(c) Information Department

13. This will be responsible for the timely flow of information to the market and the investing public. Duties will cover:

(a) receipt and dissemination of company information;

(b) provision of information to Listing Division; and

(c) liaison with surveillance area on market monitoring.

14. The immediate tasks facing the Listing Division are recruitment, assembling a data base and putting together systems. The duties of the Listing Committee are to be fixed.
Strengthening of the surveillance capabilities

15. The Surveillance Department is under the management of a London-trained chartered accountant who joined the Exchange in August 1987. A leading accounting firm was engaged to advise on the future staffing of the Department and on the necessary procedures for the better surveillance of members' firms. In addition, the firm has seconded staff under a partner to work in the area of members' surveillance. They are assisted in legal matters by the Exchange's legal advisers. A senior accountant will shortly join the Exchange to become the Head of the Compliance Division of which the Surveillance Department will form a part.

Tightening up financial control

16. The accounting firm also undertook a review of the finances of the Exchange. Steps have been taken to implement a proper system of budgetary control and a new computerised financial accounting system. These should be operational before the second half of 1988. Pending the recruitment of permanent accounting staff to run the Finance Division, staff from the accounting firm have been seconded to the Exchange to control the day-to-day accounting functions. The permanent head of the department, an experienced chartered accountant, has now been recruited.

17. In addition, the considerable reserves of the Exchange have been put under proper management. In February 1988, $100 million of the Exchange's reserves have been contracted out to a fund manager for a period of 12 months. The remainder is retained in the form of short-term deposits pending finalisation of the cash flow projections of the Exchange.

Strengthening of the staff and operations

18. Another consulting firm was engaged to review and advise on executive renumeration and to assist in the general recruitment of staff.

19. Recruitment for staff of the Operations Division, covering trading, settlement and the general provision of technical services to the Exchange, is under way. Particular attention is being paid to the provision of technical services for effective market surveillance and for the flow of information to the market from the Listing Department. Resources are also being dedicated to develop short- and long-term settlement systems and to computerise listings, membership and accounts returns.
APPENDIX 18

REPORT ON THE LISTING RULES AND PROCEDURES OF THE STOCK EXCHANGE OF HONG KONG: SUMMARY OF RECOMMENDATIONS

The International Stock Exchange (ISE) in London was appointed to review the Listing Rules and procedures of the Listing Department of the Stock Exchange of Hong Kong in early 1988. Its report identified three major areas for improvement.

The Exchange Listing Rules

2. The ISE recommended two categories of amendments to the Listing Rules, namely: -

Category (1) parts of the Rules needing general enhancement to reflect current best practice; and

Category (2) specific matters to be addressed by revising individual listing rules.

3. Regarding Category (1), the ISE recommended that:

(a) the content of prospectuses and circulars to shareholders should be enhanced. Consideration should be given to incorporating requirements for reports from the sponsor and reporting accountants on profit forecasts, and the inclusion of statements regarding material changes, if any, in the issuer's financial position since the date of its latest annual accounts;

(b) the requirement to include an accountants' report and the information to be disclosed therein should be expanded so that accountants' reports reflect best practice under the generally accepted accounting principles in Hong Kong; and
(c) the content of the listing agreement should be expanded to reflect best practice for conduct of and disclosure of information by listed companies, as well as providing for reduced requirements for issuers with only debt securities listed.

4. Regarding Category (2), the ISE recommended a number of amendments to the Listing Rules on (a) trading record; (b) major disposals and shell companies; (c) acquisitions and disposals; (d) placings and introductions; (e) offers for subscription or sale - the queue system; (f) warrants to subscribe and; (g) role of the sponsor.

Company information

5. The ISE believe that to maintain public confidence in the marketplace, board deliberations should be made in strict confidence. Third parties should be informed only when a decision has been reached. Once communication is to be made, the news must be made available as quickly as possible to the widest spectrum of the public. This will entail establishment of a central focus for collation and dissemination of news to the market to enable the price of a security to reflect the latest information thus putting both parties to a transaction in the securities in possession of the same knowledge.

Organization of the Listing Department

6. The ISE pointed out the importance of striking a balance in apportioning the work and responsibilities of the Committee and the executive of the Exchange. To achieve this, there should be more delegation from the Committee to the executive.

7. Regarding the internal structure and composition of the Listing Department, the ISE recommended that there should be more staff working in less cramped office accommodation to enhance the quality of regulation of listed companies.
APPENDIX 19

THE STOCK EXCHANGE OF HONG KONG

SUSPENSION OF LISTINGS
(April 1986 - March 1988)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Total</th>
<th>one day or less</th>
<th>one week or less</th>
<th>longer</th>
<th>(still) suspended</th>
<th>Suspension at the authorities' request</th>
</tr>
</thead>
<tbody>
<tr>
<td>II 1986</td>
<td>17</td>
<td>8</td>
<td>5</td>
<td>4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>III 1986</td>
<td>18</td>
<td>4</td>
<td>10</td>
<td>4</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>IV 1986</td>
<td>35</td>
<td>13</td>
<td>8</td>
<td>14</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>I 1987</td>
<td>32</td>
<td>9</td>
<td>17</td>
<td>6</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>II 1987</td>
<td>23</td>
<td>7</td>
<td>15</td>
<td>1</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td>III 1987</td>
<td>48</td>
<td>15</td>
<td>28</td>
<td>5</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>IV 1987</td>
<td>39</td>
<td>10</td>
<td>13</td>
<td>16</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>I 1988</td>
<td>19</td>
<td>5</td>
<td>10</td>
<td>4</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

|             | 231   | 71              | 106              | 54     | 8(1)             | 5                                     |

(1) Included in the preceding column of figures of company requested suspensions longer than one week.

Source: The Stock Exchange of Hong Kong Limited.
APPENDIX 20

INTERIM MEASURES TO MITIGATE SETTLEMENT AND REGISTRATION PROBLEMS SUGGESTED IN THE SUBMISSIONS TO THE SECURITIES REVIEW COMMITTEE

(a) To open a central clearing room where brokers could meet daily for collective clearing.

(b) To lengthen the settlement period.

(c) To move to a system where trades are value-dated i.e. for delivery on a mutually agreed specified day.

(d) To put the transfer form onto the back of share certificates, so as to reduce the amount of paper.

(e) To standardise the board lot size which at present varies between 100 and 5,000 shares depending on the company.

(f) To increase the board lot size of companies with low share trading price so as to reduce the amount of share certificates to be transferred.

(g) To standardise transfer forms which are currently company-specific.

(h) To introduce a system of certified transfers which involves the registrar issuing (pending registration) a piece of paper which states that, on a first check, they are satisfied the holder is a proper transferee; certified transfer forms would be negotiable and could be split to facilitate partial re-sale.

(i) As a variant of (i), to introduce depository receipts (along the lines of the American Deposit Receipt which allows non-US shares to be freely traded in the US) which would be issued by a bank custodian and give title to shares held by the bank. The depository receipt could be freely traded as a bearer instrument.

(j) To change the stamp duty rules in order to make stock lending cheap and easy.

(k) To reduce the period required for the registration of shares.

(l) To introduce a system of record dates for rights issues etc rather than close the books for a period.
APPENDIX 21

STOCK INDEX FUTURES

Introduction

This appendix summarises the construction and functions of stock index futures and the trading strategies used in derivative product markets (1).

2. Stock index futures were first introduced by the US Kansas City Board of Trade on 4 February 1982. The Chicago Mercantile Exchange opened trading in the S&P 500, by far the most active contract in the world, just two months later. Since then, stock index futures contracts have mushroomed, with over half a dozen in the US; one in the UK; one in Australia; one in Japan (with another on the way); one in Singapore; and one in Toronto. And of course the Hong Kong Futures Exchange (HKFE) introduced the Hang Seng Index contract in May 1986.

3. Because a futures contract is a single instrument which mirrors, and can therefore be used as a surrogate for, a basket of stocks, it opens up a whole range of possible trading strategies.

Hedging

4. An investor in a portfolio of stocks which is identical to or closely tracks the index is able to hedge his exposure to price movements by selling index futures. Provided the futures market accurately tracks the cash market, any losses in the cash market (2) should be offset by corresponding gains in the futures market. The opposite also applies, however. Any gains in the cash market will be foregone through equivalent losses in the futures market; in consequence, if the hedge were always maintained, the attractions of investing in stocks would be significantly reduced.

(1) A "derivative product" is an instrument which is based on another instrument or product. Futures and options are both examples of derivative products.

(2) "Cash market" is an expression used to refer to the market in the underlying instruments – in this case, the stock market where the constituents of the index are traded.
5. Hedging might therefore occur when an investor with an open cash market position wishes to lock in his profit because he has become nervous about market conditions. His confidence might later recover, causing him to unwind his futures position (possibly at a cash loss) in order to re-open his cash market position. Alternatively, he might use the futures market actively, locking in his profits at successively higher levels, although that increases transaction costs of course. A hedge position might also be taken if the investor is looking for income rather than capital gain.

6. In addition, an investor in a single stock is able to reduce his exposure to general market movements by selling index futures. His residual exposure is to movements in the price of the particular stock against the market (a risk measured by the stock's beta factor). This strategy might be used by merchant banks and institutional underwriters to a new issue.

7. The hedger cannot guarantee to eliminate risk, however, as the hedge will be imperfect whenever his portfolio behaves differently from the index; or the relationship between the futures contract and the underlying index behaves in an abnormal or unexpected way.

Speculation

8. A speculator is someone who is prepared to punt on the market rising or falling by taking on an open position. Because transaction costs are considerably lower in the futures market than in the cash market, stock index trading is particularly attractive to speculators. First, the bar to entry is lower. Secondly, the gearing is better: for simplicity, assume a futures market margin requirement of 10% and a cash market margin requirement of 50%; in the futures market, a speculator with a long position can double his money if prices rise 10%; in the cash market, prices must rise by five times as much for the same return to be secured.

9. It is helpful, for analytical purposes, to put speculators into two groups - those who will take overnight or even longer exposures; and those who take intra-day open positions. So-called "locals" typically only take intra-day positions, jobbing in and out of the market to exploit short-term price fluctuations. As such they provide useful liquidity to the market and might even be regarded as quasi market-makers. But, as the events of October 1987 demonstrated, they may not stay around in violent markets - it is simply too dangerous; they are certainly not under any obligation to make markets.
Index arbitrage

10. The difference between the value of the index and the futures contract is called the "basis". This should not be too great as the value of a futures contract should obviously track the value of the underlying index, with the two converging at the delivery date. There are a number of factors making for slight differences, however:

(a) the future is worth more to the extent that the investor saves the financing costs of holding the underlying portfolio; but

(b) it is worth less to the extent that the futures investor foregoes the dividend income received by an investor in the underlying stocks.

11. The theoretical value of the future is therefore determined by the prevailing interest rate, the prevailing dividend rate, the time left to expiry, and relative transaction costs; in combination, this is referred to as the "cost of carry". In most markets, the future's theoretical value has typically been slightly greater than the underlying index in recent years.

12. In practice of course, the future does not stick to its theoretical course. Stock index arbitrage is designed to exploit such divergences. This is possible because, whatever the divergences during a contract period and whatever the volume of arbitrage activity, the prices will converge at the expiry date as the delivery (or settlement) price is determined by the cash price.

13. Thus, if the future is at a sufficient premium to the cash, the arbitrageur buys in the cash market (3) and sells futures. Or, if the future is at a discount to its theoretical value - perhaps in dull or bearish markets - the arbitrageur buys the future and sells in the cash market (i.e. he takes a short position in the stock market).

(3) In practice, given the costs of assembling the whole of the index in the cash market, an arbitrageur will usually attempt to replicate the index with a smaller basket of securities which closely tracks the index.
14. One of the important features of arbitrage therefore is that, in efficient markets, it should bring prices back into line - i.e. when the premium is too high arbitrageurs selling the future and buying the cash in sufficient volumes should depress futures prices and underpin cash market prices. Theoretically, if it goes too far, reverse arbitrage opportunities arise, and so on until equilibrium is reached.

15. It should be noted that, as the arbitrageur is locking in to a hedged position at a fixed rate of return, arbitrage can be an attractive strategy, particularly if the abnormally large premium (or discount) occurs near the beginning of a contract period. For example, if the premium on day 10 of a 30-day contract is 1%, this is equivalent to 0.05% per day remaining before expiry, providing an annualised return of slightly over 18%, before transaction costs and the cost of funding the long cash market position. Arbitrage is therefore attractive to fund and money managers looking for a high yield investment; indeed the transactions can be viewed as a synthetic money market operation.

16. Opportunities to roll-over an arbitrage position into a more distant contract period can arise when the premium (or discount) is fairly constant; the existing future is bought back (or sold), with the new contract being sold (or bought). This is particularly attractive for a long arbitrageur (4) as the same stock position can be used. It is slightly more tricky for a short arbitrageur as he must re-establish his short position (or extend his stock borrowing commitment).

17. An arbitrageur's expected profit may not be realised, however, if the constructed basket of stocks ceases to track the market, or if the execution of trades has a material impact on the market. The most extreme case would be where, in unwinding a long cash market position, the sale of stocks depressed the market to the extent that some of the basket was sold at lower than expected prices. Furthermore, problems could be experienced in unwinding a large long arbitrage position in a bear market as the arbitrageur may not be able to find buyers.

(4) A "long arbitrageur" has a long position in the stock market and a short position in the futures market.
18. Finally, it should be noted that an arbitrageur does not have a direct interest in holding the underlying stock portfolio — he is not an investor. At the expiry date (or before if relative prices move back into line), the arbitrageur settles or reverses his transaction in both markets. This can lead to significant stock selling/buying, which was one of the factors lying behind the "triple witching hour" phenomenon in the US. The arbitrageur's "lack of interest" in the spot market is also one of the elements which, it is said, can contribute to a "cascade scenario" (see below).

**Index substitution**

19. The development of institutional investment and pooled investment schemes over the past decade or so is based, inter alia, on the premise that an investor should in the long run improve his return by holding a diversified basket of stocks and shares. In recent years, there has been growing criticism of fund managers' failure to out-perform the index. Faced with the difficulty of beating the market, they have tended to simply buy the whole market. This has prompted the growth of so-called index funds, which are carefully constructed to replicate (or at least nearly match) the index in terms of constituent stocks, relative weightings etc.

20. Two consequences are first that investors become relatively more interested in events which impact on the market as a whole as opposed to developments concerning individual securities. And secondly, that the investor can just as easily buy the index via the futures market; and indeed, it will usually be cheaper to do so.

21. As well as taking naked long positions in the futures market to replicate the index, an index fund might also engage in a form of arbitrage. If the future trades at a discount to its theoretical level, the fund may buy futures and sell stocks, investing the proceeds in money market instruments and thus enhancing the yield achieved by the fund relative to the market. The stock sales may be actual, so that this activity can occur in markets which bar short sales — such as Hong Kong; and can continue when prices are falling in markets where short selling is only permitted on an uptick— such as the US.
Portfolio insurance

22. Most portfolios are not 100% equities but rather a mixture of equities, bonds and cash, with the balance being varied from time to time according to expectations of prospective market performance and changing risk/return equations. Thus, if an investor begins to feel jittery about the market, he will typically reduce the equity element and increase bond/cash element (in this context bonds may be regarded as cash).

23. Traditionally this has involved the actual sale and later re-purchase of equities etc. Portfolio insurance is a trading strategy which involves using futures to adjust the de facto level of securities and cash in the portfolio without actually having to trade in the securities market. Given transaction costs in the futures market are generally lower, it should save money and give fund managers greater flexibility.

24. For example, if an investor develops bearish sentiments, he will sell futures creating a hedged synthetic cash position for part of the portfolio, thereby reducing the de facto equity element of the portfolio. Conversely, if the investor is bullish, he buys futures to increase the de facto equity weighting of the portfolio.

25. In some instances portfolio insurance has apparently been used to "guarantee" a certain level of return, with the strategy being used semi-automatically; a specified fall/rise in stock prices triggers the sale/purchase of a specified amount of futures.

26. Because adjustments are made on a continual basis, portfolio insurance is sometimes referred to as "dynamic hedging".

Programme trading

27. Programme trading is a generic term used to describe the practice of using computer programmes to indicate when and how to implement one or any of the trading strategies described above. It does not involve the automatic, computer driven execution of such strategies. Examples would involve a computer calculating when arbitrage would be profitable taking all the costs into account; or triggering portfolio insurance futures selling when the stock index fell by a specified amount.
APPENDIX 22

HISTORY AND DEVELOPMENT OF
THE HONG KONG FUTURES MARKET

Background

From 1910 to 1977 the only commodities trading in
Hong Kong was at the Chinese Gold and Silver Exchange
Society, which was and is completely self-regulated. This
was because of lack of interest rather than regulation as
up to 1973 there were no legal constraints on commodity or
futures trading.

2. However, on 20 June 1973, when several groups
expressed an interest in setting up commodity exchanges,
the Government announced a temporary ban which was followed
in August by the introduction of legislation, the Commodity
Exchanges (Prohibition) Ordinance (Cap. 82), preventing the
establishment and operation of new commodity exchanges
until such time as their desirability had been determined
and further legislation had been enacted for their proper
regulation. The Ordinance did not apply to the Gold and
Silver Exchange.

3. Having applied this brake, the Government
established a Steering Group to assess the feasibility
studies being prepared by the various interested parties.
In 1974, the Group concluded, inter alia, that -

(a) the establishment of a properly regulated
and controlled commodity exchange would,
on balance, bring financial and economic
benefits to Hong Kong;

(b) a commodity futures exchange was by nature
a market of professional traders and its
rules should discourage the participation
of the ordinary public;

(c) its main function would be to provide
hedging facilities against fluctuations in
prices of raw or semi-processed materials;
and

(d) it could not succeed if it had purely
local participation.

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Establishment of the Hong Kong Commodities Exchange

4. In 1975, the Legislative Council approved in principle the proposal to establish a commodity exchange in Hong Kong provided that social hazards to the ordinary citizens of Hong Kong could be minimized. The Commodities Trading Ordinance was subsequently enacted to enable the opening of an exchange in Hong Kong and to regulate futures trading. In 1977, a licence was issued by the Governor-in-Council to the Hong Kong Commodities Exchange Limited (HKCE), subject to a review after five years.


6. As required under the terms of the licence, the Government established a Working Party in 1982 to review the Exchange and the Commodities Trading Ordinance. The Working Party completed its review in November 1983, concluding that the HKCE had not been a success. There were quite severe management problems and it had not brought any significant advantage to local commodities users.

Seacom Holdings

7. The genesis of these management problems lay in Seacom Holdings which was owned by a group of Hong Kong business interests had been authorised by the Government in 1974 to promote the formation of a commodity exchange. In effect the Exchange was to a large degree controlled by Seacom which had the right to appoint the President of the management committee and the Secretary of the Exchange and to nominate half the board of directors.

8. International Commodities Clearing House (ICCH) negotiated its appointment as clearing house with this group who sought to establish an arrangement whereby they would be joint owners of the clearing house and thus share the profit with ICCH. ICCH however rejected this idea on the grounds that it would not be able to carry out its function in an independent manner if the promoters, who were also potential members of the Exchange, were able to influence decisions at Board level.

9. As an alternative to taking equity in the clearing house Seacom was offered equity in the Guarantee Corporation. This alternative was rejected by them when they realised the potential risk that they would be taking
on. Agreement was, however, reached just prior to commencement of trading on the new Exchange whereby Seacom were to be paid a commission on each registration fee collected by ICCH. The amount of commission to be paid was based on a sliding scale according to turnover.

Re-organisation of the Hong Kong Futures Exchange

10. On the basis of the Working Party's recommendations, the Government decided in 1984 to renew the licence of the Exchange provided that -

(a) the Exchange was re-organized to widen its membership and strengthen its executive and Board;

(b) efforts were made to develop new contracts with larger local appeal and international characteristics to improve its viability; and

(c) the Commodities Trading Ordinance was appropriately amended to strengthen the prudential supervision of the Exchange.

11. The Government also decided that a further licence review should be conducted three years later to check whether these conditions had been met.

12. At around this time, a new chairman, Dr. Kim Cham, was appointed and a series of management improvements were introduced.

Hang Seng Index Futures Contract

13. In the course of the licence review, a consortium of banks put forward a comprehensive proposal to establish a financial futures market in Hong Kong. To avoid having two separate exchanges, the Government encouraged the consortium to work with the HKCE to develop joint proposals for a financial futures market in Hong Kong. This culminated in an HKCE proposal to change its name from "Commodities" Exchange to "Futures" Exchange and to broaden its membership to include, inter alia, subsidiaries of banks. It further proposed that a stock index future should be the first contract.

14. The proposed contract was approved by the Government in 1984 when the licence of the Exchange was renewed.
The Vercelli Agreement

15. The Government's new proposals meant that Seacom no longer enjoyed special status as the original promoter of the Exchange. The parties who owned the defunct Seacom were allowed to retain an interest in the profits earned by ICCH but not directly as before from a commission arising from registration fees. Instead they formed a new company called Vercelli Company Limited which entered into a consultancy contract with ICCH(HK) to promote the HKFE. In return for carrying out these consultancy duties Vercelli was to be paid an annual fee proportional to the current and expected profits of ICCH(HK). The consultancy contract was terminated in October 1987.

Trading Volumes

16. Trading in the Hang Seng Index futures contracts commenced in May 1986 and quickly exceeded the other contracts in volume, accounting for 80% of the total market turnover of the Exchange in 1987 (1). However, boom had led to bust by October 1987.

(1) Monthly trading volumes and relative market share of the various contracts on the HKFE from January 1986 to April 1988 are contained in Tables 1 and 2 below.
### TABLE 1

Monthly trading volumes (in lots) of various contracts on the HKFE January 1986 to April 1988

<table>
<thead>
<tr>
<th></th>
<th>Hang Seng Index</th>
<th>Soybeans</th>
<th>Sugar</th>
<th>Gold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986 (monthly average)</td>
<td>103160</td>
<td>27544</td>
<td>22817</td>
<td>531</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Jan</td>
<td>185380</td>
<td>26311</td>
<td>33030</td>
<td>488</td>
</tr>
<tr>
<td>Feb</td>
<td>222859</td>
<td>51468</td>
<td>27608</td>
<td>522</td>
</tr>
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<td>Mar</td>
<td>323361</td>
<td>26332</td>
<td>38850</td>
<td>574</td>
</tr>
<tr>
<td>Apr</td>
<td>276529</td>
<td>38228</td>
<td>23420</td>
<td>520</td>
</tr>
<tr>
<td>May</td>
<td>293001</td>
<td>63969</td>
<td>22894</td>
<td>546</td>
</tr>
<tr>
<td>Jun</td>
<td>340994</td>
<td>48885</td>
<td>18097</td>
<td>520</td>
</tr>
<tr>
<td>Jul</td>
<td>420505</td>
<td>49419</td>
<td>20247</td>
<td>600</td>
</tr>
<tr>
<td>Aug</td>
<td>483389</td>
<td>47683</td>
<td>14910</td>
<td>518</td>
</tr>
<tr>
<td>Sep</td>
<td>601005</td>
<td>67619</td>
<td>22193</td>
<td>574</td>
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<tr>
<td>Oct</td>
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<td>22764</td>
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<td>Nov</td>
<td>47194</td>
<td>71674</td>
<td>17371</td>
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<td>Dec</td>
<td>17486</td>
<td>59108</td>
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<td>176</td>
</tr>
<tr>
<td>1988</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan</td>
<td>15471</td>
<td>34160</td>
<td>20226</td>
<td>160</td>
</tr>
<tr>
<td>Feb</td>
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</tr>
<tr>
<td>Mar</td>
<td>14388</td>
<td>36899</td>
<td>15372</td>
<td>184</td>
</tr>
<tr>
<td>Apr</td>
<td>16247</td>
<td>29047</td>
<td>11559</td>
<td>144</td>
</tr>
</tbody>
</table>

Source: Hong Kong Futures Exchange Ltd.
### Table 2

Relative market share of the various contracts on the HKFE
1986 to 1988 (January to April)

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
<th>1988 (Jan to Apr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hang Seng Index</td>
<td>89784</td>
<td>585078</td>
<td>7208 (41.7)</td>
</tr>
<tr>
<td>Soybeans</td>
<td>17756</td>
<td>38936</td>
<td>9389 (54.3)</td>
</tr>
<tr>
<td>Sugar</td>
<td>2225</td>
<td>2448</td>
<td>679 (4.0)</td>
</tr>
<tr>
<td>Gold</td>
<td>242</td>
<td>260</td>
<td>30 (0.2)</td>
</tr>
</tbody>
</table>

Figures in brackets refer to the percentage of total turnover. Where they do not add up to 100%, this is because of rounding up.

Source: Hong Kong Futures Exchange Ltd.
APPENDIX 23

THE HANG SENG INDEX MARKET

In this Appendix we briefly summarise the development of the Hang Seng Index (HSI) futures market from its launch in May 1986 to its nadir in October 1987. Our assessment of the contract and the market is contained in Chapter VI.

The Hang Seng Index

2. The index futures contracts traded on the HKFE are based on the Hang Seng Index, which is compiled and managed by HSI Services Ltd., a wholly owned subsidiary of Hang Seng Bank Ltd. The index was launched in November 1969, using 31 July 1963 as the base date (using 100 as the base figure) and is the most widely quoted indicator of general price movements on the Hong Kong stock market. It is computed and released once a minute through the Teletext system of the Stock Exchange and Reuters Monitor Equities Investment Service. A Hang Seng Index Daily Bulletin recording the level of the index at 15 minutes intervals and high/low/close for each day, is also published.

3. The index comprises 33 stocks and is capitalisation weighted; the respective weightings of the individual components is shown in Annex 1.

4. Although the number of companies listed on the Hong Kong stock market has increased from 73 in 1969 to over 270, the Hang Seng Index has consistently represented between 75% and 80% of the market in terms of both market value and turnover. It was put to us that the index could therefore fairly be regarded as representative of the market.

5. The Hong Kong market has two characteristics which are likely to affect the susceptibility of the index to manipulation (1). First, the dominance of a few companies. Significant movements in the share prices of some of the largest companies have a major impact on the HSI (2). Second, extensive cross-holdings; we were advised that, in terms of market value, the five largest groups accounted for over 43% of the market. Substantial trading

-----------------------------------------------
(1) Annex 2 sets out the considerations affecting index future manipulation.

(2) This also makes it easier to construct a small basket of shares that tracks the index fairly accurately, and thus makes arbitrage cheaper and easier.

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within these groups would also have a significant impact on the movement of the index. However, a broader-based index would not significantly reduce the impact of sharp price movements in the major stocks. For example, the Hong Kong Index, developed by SEHK on unification, which covers 49 stocks, nevertheless accounts approximately for only 70% of turnover and 80% of total market capitalisation.

6. Another possibility is to move to a non-capitalisation weighted index. Although we have not studied this in detail, a preliminary analysis indicates that price changes in some of the smaller stocks would have a disproportional effect on the index when their importance to investors and the economy is considered. Moreover, because some of these lesser stocks relatively illiquid, their inclusion might actually increase the risks of manipulation and disorderly markets.

7. Our initial conclusion is that the index reflects the inherent structural features of the market itself and, in the circumstances, is probably the best available to track price movements on the stock market. However, this does not necessarily mean that it is the best available basis for an index futures contract.

**HSI contract terms**

8. The HSI future contract has the following terms:

- **Base**
  - the Hang Seng Index

- **Contract type**
  - cash settled futures

- **Contract multiplier**
  - HK$50

- **Minimum fluctuation**
  - one index point, or $50

- **Expiration date**
  - second last business day in the nearest three consecutive months (called the spot, first and second months)

- **Settlement/expiry price**
  - the average of quotations for the HSI taken at five minute intervals throughout the last trading day.
9. Compared with index contracts elsewhere, two relatively unusual features may be noted immediately. First the contract multiplier is small; the result is that, at current prices, the face value of one HSI future contract is one-fifth of a FTSE 100 contract and one-eighth of an S&P 500 contract. Secondly, trading is for one, two and three months out whereas the international norm is for three, six and nine months.

**Growth of the market and trading patterns**

10. The Hang Seng Index futures contract was introduced in May 1986. As Chart 1 shows turnover rocketed, from 31,070 contracts in May 1986 to a record 601,005 in September 1987. Over the same period, net open interest (3) increased from about 2,000 contracts to 25,000 contracts and gross open interest from 6,000 to 54,000 (4). The rates of growth compared with the value of the underlying index are illustrated below -

<table>
<thead>
<tr>
<th>Period</th>
<th>HKFE Volume (5)</th>
<th>HKFE Net Open Interest</th>
<th>SEHK Volume</th>
<th>SEHK Closing Price of HSI</th>
</tr>
</thead>
<tbody>
<tr>
<td>May '86 - Sept '87</td>
<td>19.0x</td>
<td>13.0x</td>
<td>6.8x</td>
<td>2.2x</td>
</tr>
<tr>
<td>Jan '87 - Sept '87</td>
<td>3.2x</td>
<td>1.8x</td>
<td>2.3x</td>
<td>1.5x</td>
</tr>
<tr>
<td>Jun '87 - Sept '87</td>
<td>1.8x</td>
<td>1.3x</td>
<td>2.2x</td>
<td>1.3x</td>
</tr>
</tbody>
</table>

11. Futures investors were rushing into the market on account of bullish sentiments. As would be expected, by the middle of every month trading in first month futures

(3) A broker's net open interest is the net of his long and short positions. The net open position of the market is the number of unsettled contracts in the whole market. A broker's gross open interest is the sum of his house and individual client account positions.

(4) See Chart 2.

(5) Definitions: Volume is the number of contracts traded during the month in the case of the HKFE, and the number of deals struck in the case of the SEHK.
exceeded spot trading. However, as time passed and in particular from the beginning of 1987, the general bullishness showed through in an increasing disposition to take open positions in the first and second month contracts. During the summer of 1987, the net open position in first month futures would exceed the net open position in the spot month from very early in each month. In consequence, when the market crashed in the week beginning 19 October, most of the open interest was in November rather than October spot futures. Since hedgers and arbitrageurs frequently want to lock into the furthest month out, this could only happen because the speculative interest on the long side of the market was getting braver.

12. Throughout the period, the future's theoretical value was at a premium to the cash price, not least because money was costing less than shares were yielding (another phenomenon of the bull market). Moreover, the future frequently traded at a much higher premium, providing attractive returns for arbitrageurs. Indeed it was suggested to us that returns as high as 30% per annum had sometimes been achieved, against a prime rate of no more than 8% during 1987. The persistence of such high premiums would indicate that the speculative forces on the long side of the market consistently outweighed investors on the short side of the market and may actually suggest a lack of sufficient arbitrageurs to ensure efficient pricing (6).

13. From September onwards, the premium became particularly high. It was put to us that this may have been due to a major build up of long positions in the expectation of a take-over offer for Hong Kong Land, one of Hong Kong's largest and most significant quoted property companies.

14. It is instructive to consider the impact which arbitrage may have had on turnover in the two Exchanges. Given a consistently rising market, it is reasonable to assume that long arbitrage positions were held at least until expiry or even rolled over. Anecdotal evidence suggests roll-overs were fairly commonplace, and became virtually automatic in the run-up to 19 October. On this basis a rough statistical test indicated that, even assuming that all short positions were part of arbitrage programmes, the impact on SEHK daily volumes averaged between 4-6% during the three months up to 16 October and much less during earlier months.

Volatility and margins

15. Stock index futures markets are frequently described as causing an increase in stockmarket

(6) Chart 3 supplied by a broker shows the premium of futures to cash since May 1986.
volatility. The position in Hong Kong leading up to and since the HSI contract was introduced up to end-September has been examined by Andrew F Freris, Head of the Department of Business and Management at the City Polytechnic of Hong Kong (7). A series of tests showed there had not been a statistically significant increase in inter-day volatility but that intra-day volatility had increased.

16. As Chart 4 shows, volatility was well covered by margin levels until the crash.

Position at the time of the crash

17. In considering the passage of events over the week or so of the October market crash, it is important to remember that Hong Kong is 12 hours ahead of New York, where the worldwide decline began; Hong Kong's market therefore closes each day before New York is open. Thus, given the worldwide fall started in the US, Hong Kong was relatively unscathed on 16 October 1987 while New York saw sharp falls. In particular, whereas futures were trading in Chicago at a discount to the cash market in New York towards the end of the day (8), this did not occur in Hong Kong; both the October and November HSI futures traded at a significant premium all day on 16 October 1987 - see Chart 5. Volumes in both contract months showed a slight increase over the 15th.

18. The picture changed on Monday 19 October. The December and November contracts traded limit down at 10.16 hrs and 11.05 hrs respectively after falling 150 points; trading the spot month was halted at 11.27 hrs after falling 180 points. All were suspended for the remainder of the session. The same happened in the afternoon session which commenced at 14.00 hrs; the contracts stopped trading at 14.54 hrs, 14.58 hrs and 15.07 hrs respectively. In consequence, although there was considerably more activity in the spot month than in the November contract because time horizons became shorter, volumes fell dramatically; spot month volumes were almost 40% lower and November contract volumes over 80% lower than the previous week's averages. During the brief periods of trading, the contract traded at a premium to the cash market (see Chart 6).

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19. As already reported in Appendix 1, the market did not open again until Monday 26 October, as the HKFE Board was forced to suspend trading by the SEHK's four day closure. In the interim, it became apparent that, on re-opening, the stock market was likely to fall dramatically, that there would be very large margin calls on investors with long positions and that there would be significant defaults.

20. The net open interest in the market at the close of business on 19 October was around 35,000 contracts, equivalent to around $7bn worth of stock. It was estimated that well over half of the short side of the market was made up of arbitrage positions and that in terms of dollar values, there was an overhang of between $4bn and $6bn of stock purchased in connection with arbitrage programmes. If the futures market collapsed, these positions would have to be liquidated depressing stock prices even further, with all the consequences to the economy that that might bring. One feature of the rescue package described in Appendix 1 to the Report was accordingly that long arbitrage positions should be unwound gradually. It seems this was achieved.

21. When the market re-opened at 11.00 a.m. (9) on Monday 26 October, trading in the spot month was permitted without limit but 300 point limits were put on the November and December contracts. All the volume was in the spot month, with November and December closing limit down without trading. As Chart 7 shows, the October future rapidly fell to a large discount to the cash market, which may have brought buyers into the ring.

**Make-up of the market**

22. The spectacular growth in the market came almost entirely from increased institutional and retail client interest. Clients accounted for nearly all the business on both sides of the market, as the following shows for the net open long positions:

<table>
<thead>
<tr>
<th>Date</th>
<th>House account</th>
<th>Clients</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 June '87</td>
<td>1195 (7%)</td>
<td>16,326 (93%)</td>
<td>17,521</td>
</tr>
<tr>
<td>1 July '87</td>
<td>942 (5%)</td>
<td>18,748 (95%)</td>
<td>19,690</td>
</tr>
<tr>
<td>3 August '87</td>
<td>1418 (7%)</td>
<td>17,851 (93%)</td>
<td>19,269</td>
</tr>
<tr>
<td>1 September '87</td>
<td>2208 (10%)</td>
<td>22,588 (90%)</td>
<td>24,796</td>
</tr>
<tr>
<td>1 October '87</td>
<td>1081 (4%)</td>
<td>23,870 (96%)</td>
<td>24,951</td>
</tr>
<tr>
<td>16 October '87</td>
<td>2193 (6%)</td>
<td>34,490 (94%)</td>
<td>36,683</td>
</tr>
</tbody>
</table>

(9) An hour later than usual.
23. Save in one other important respect, it is apparent that the long and short sides of the market were completely different in character. The long side was almost wholly speculative and had a large retail element; there were many reports of taxi-drivers and amahs playing the futures market. The short side was largely institutional, with 50% or more being arbitrageurs.

24. But on both sides of the market, the business was concentrated in the hands of a few brokers. Three brokers accounted for over 50% of the net long positions (out of a total of seventy-five net long brokers); and five brokers accounted for nearly 90% of net short positions (out of a total of twenty-seven net short brokers). Some of these brokers held large positions on both sides, but still had resultant large net positions. They were therefore particularly exposed to a major collapse.

25. Finally, roughly 50% of the long positions were held by a single client and associates. In short, there was a major risk concentration problem, with the market depending on the ability of a few brokers and investors to support very large positions relative to the market, and, in some case, their net worth.

26. The position during the week of 19 October was therefore as follows. The longs were exposed to a sharp decline in futures prices, particularly given lax margin collection and extensive credit extensions, thereby raising the spectre of massive defaults. The shorts were exposed because first, they might not be able to collect their winnings from the futures market to pay their clients and second, a significant proportion of their clients were arbitrageurs and therefore held stock market positions which were rapidly diminishing in value. It has also been suggested to us that as prices rose, some clients with short positions met their futures market variation margin commitments by borrowing against stock holdings which were purchased in the first place through margin facilities. In consequence, when the crash came, brokers on the short side also faced the prospect of client defaults in so far as they are not able to cover their stock losses from their futures profits if the long position holders defaulted.

27. To sum up, most of the major players in the market had substantial exposures in the event of a market collapse.
# Annex 1

## HANG SENG INDEX CONSTITUENTS
(as at end April 1988)

<table>
<thead>
<tr>
<th>Company</th>
<th>Effect on HSI (in points)</th>
<th>% of HSI Capitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Bank of East Asia Ltd.</td>
<td>0.06</td>
<td>0.75</td>
</tr>
<tr>
<td>Hang Seng Bank Ltd.</td>
<td>0.45</td>
<td>4.60</td>
</tr>
<tr>
<td>The Hongkong and Shanghai Banking Corporation</td>
<td>1.69</td>
<td>8.61</td>
</tr>
<tr>
<td>Jardine Strategic Holdings Ltd.</td>
<td>0.22</td>
<td>1.63</td>
</tr>
<tr>
<td><em>Finance</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China Light &amp; Power Co. Ltd.</td>
<td>0.75</td>
<td>5.29</td>
</tr>
<tr>
<td>The Hong Kong &amp; China Gas Co. Ltd.</td>
<td>0.29</td>
<td>1.85</td>
</tr>
<tr>
<td>Hongkong Electric Holdings Ltd.</td>
<td>0.59</td>
<td>3.49</td>
</tr>
<tr>
<td>Hong Kong Telecommunications Ltd.</td>
<td>3.12</td>
<td>17.03</td>
</tr>
<tr>
<td>The Kowloon Motor Bus Co. (1933) Ltd.</td>
<td>0.21</td>
<td>1.03</td>
</tr>
<tr>
<td><em>Utilities</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cheung Kong (Holdings) Ltd.</td>
<td>0.71</td>
<td>4.08</td>
</tr>
<tr>
<td>Hang Lung Development Co. Ltd.</td>
<td>0.37</td>
<td>1.53</td>
</tr>
<tr>
<td>Henderson Land Development Co. Ltd.</td>
<td>0.47</td>
<td>1.94</td>
</tr>
<tr>
<td>The Hongkong Land Co. Ltd.</td>
<td>0.81</td>
<td>5.24</td>
</tr>
<tr>
<td>Hongkong Realty and Trust Co. Ltd.</td>
<td>0.07</td>
<td>0.49</td>
</tr>
<tr>
<td>Hysan Development Co. Ltd.</td>
<td>0.28</td>
<td>0.98</td>
</tr>
<tr>
<td>New World Development Co. Ltd.</td>
<td>0.73</td>
<td>2.91</td>
</tr>
<tr>
<td>Sun Hung Kai Properties Ltd.</td>
<td>0.93</td>
<td>3.85</td>
</tr>
<tr>
<td>Tai Cheung Properties Ltd.</td>
<td>0.06</td>
<td>0.36</td>
</tr>
<tr>
<td><em>Properties</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cathay Pacific Airways Ltd.</td>
<td>0.93</td>
<td>5.15</td>
</tr>
<tr>
<td>Cavendish International Holdings Ltd.</td>
<td>0.47</td>
<td>2.42</td>
</tr>
<tr>
<td>Dairy Farm International Holdings Ltd.</td>
<td>0.21</td>
<td>1.42</td>
</tr>
<tr>
<td>Green Island Cement (Holdings) Ltd.</td>
<td>0.07</td>
<td>0.38</td>
</tr>
<tr>
<td>Hong Kong Aircraft Engineering Co. Ltd.</td>
<td>0.12</td>
<td>0.56</td>
</tr>
<tr>
<td>The Hongkong and Shanghai Hotels Ltd.</td>
<td>0.16</td>
<td>1.04</td>
</tr>
<tr>
<td>HK-TVB Ltd.</td>
<td>0.27</td>
<td>1.61</td>
</tr>
<tr>
<td>Hutchison Whampoa Ltd.</td>
<td>0.98</td>
<td>6.37</td>
</tr>
<tr>
<td>Jardine Matheson Holdings Ltd.</td>
<td>0.40</td>
<td>1.93</td>
</tr>
<tr>
<td>Mandarin Oriental International Ltd.</td>
<td>0.10</td>
<td>0.70</td>
</tr>
<tr>
<td>Miramar Hotel &amp; Investment Co. Ltd.</td>
<td>0.15</td>
<td>0.85</td>
</tr>
<tr>
<td>Swire Pacific Ltd.</td>
<td>1.02</td>
<td>6.58</td>
</tr>
<tr>
<td>The Wharf (Holdings) Ltd.</td>
<td>0.56</td>
<td>3.04</td>
</tr>
<tr>
<td>Winsor Industrial Corporation Ltd.</td>
<td>0.08</td>
<td>0.55</td>
</tr>
<tr>
<td>World International (Holdings) Ltd.</td>
<td>0.33</td>
<td>1.74</td>
</tr>
<tr>
<td><em>Commercial &amp; Industrial</em></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[
\text{Total} = 100.00\text{ points} / 100.00\text{%} = 100.00\text{%}
\]

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INDEX CONSIDERATIONS

We understand that the US authorities weigh the following considerations in addressing whether an index future will be exposed to manipulation:

(a) the number of stocks composing the index—a large number usually makes manipulation of the index, or through it, of any stock it comprises less feasible;

(b) capitalisation—total shares outstanding of component stocks times price per share. The larger this number is, the larger is the investment required for any manipulative attempt and thus the riskier the attempt becomes;

(c) depth and liquidity of secondary market—strong showings in these areas (measures primarily by volume and volatility) also makes manipulation a much larger, more hazardous and impractical undertaking;

(d) diversification—diversity of issuers and industries correlates to pricing independence among component stocks and so renders manipulation more difficult; and

(e) weighting—a system of calculating index value which gives greater weight to the prices of those stocks which are individually less subject to manipulation (due to factors like capitalisation, depth and liquidity). This type of weighting will make the index as a whole less subject to manipulation, provided the weighting does not result in the index being dominated by one or a few stocks, thus raising the diversification criterion.
H.S. Index Future - Gross Vs Net Open Interest

- Net open interest
- Gross open interest

Chart 2
-- COMPARISON --

Hang Seng Index Spot Future Vs Hang Seng Index  19/OCT/87

--- Hang Seng Index

...... H.S. Index Future - spot month

Chart 6
-- COMPARISON --
Hang Seng Index Spot Future Vs Hang Seng Index 26/OCT/87

Hang Seng Index

H.S. Index Future - spot month
APPENDIX 24

THE HONG KONG FUTURES EXCHANGE
REFORMS FOR FUTURES TRADING IN HONG KONG

In December 1987, the Hong Kong Futures Exchange Limited (HKFE) issued a package of reforms for the Hang Seng Index (HSI) market which had been agreed with ICCH (Hong Kong) Limited (ICCH) and the Hong Kong Futures Guarantee Corporation (FGC). In most cases, implementation is already underway. The main rule changes currently in place are described below.

EXCHANGE

Client relations

(a) Brokers are now required to ensure that their clients are fully aware of the risks of trading futures and acknowledge this by signing and returning a form to the broker [Rule 431].

(b) New rules have been introduced requiring members to know the identity of their clients including beneficial ownership and to establish their financial position prior to trading [Rule 431A].

(c) Members must state in each Client Agreement how long the client is given to meet margin calls and that the member will be obliged to close out a position if calls are not met [Rule 431(ii)(h)]: the extension of credit by brokers was already banned under Rule 442.

Capital requirements

(d) Full members and firms trading in the HSI market now have to have minimum paid-up capital of $5 million. This was introduced from 31 March 1988 but the Exchange may give case-by-case extensions until the end of the year [Rules 307, 321 and 325A].

(e) For all other existing markets the minimum paid-up capital has been increased from $1 million to $2 million [Rule 321].
Locals (Floor Traders)

(f) The Exchange has introduced a new category of floor traders who may trade for their own account only. As they are prohibited from trading for clients they are subject to a low $1/2 million minimum capital requirement. But position limits will be applied because of the intra-day exposures they might take [Rules 325B and C].

Reporting

(g) Members are obliged to make a monthly financial return to the Exchange within 14 days of the month end; returns were previously quarterly [Rule 418(b)].

(h) Members are now obliged to notify the Exchange if a client misses two consecutive margin calls [Rule 441A].

(i) Members are now required to report to the Exchange any client or house account large open positions. In the first instance brokers may identify clients by numbers but, when specifically requested, the identities and beneficial owners must be provided [Rules 441B and 525B]. The current reporting trigger is 100 net open positions in any contract month.

Limits

(j) Position limits based, inter alia, on a firm's net worth may now be imposed on open HSI positions [Rule 525A]. As yet the Exchange has imposed limits only on those non-clearing members who have been given a temporary waiver from the minimum capital requirements. Limits are roughly 50 net open positions for each $1 million of capital; this is around $6.2 million at current values or, with margins at 15%, an estimated exposure of around 100% of capital. (Clearing members are covered by ICCH rules - see below.)

(k) Absolute speculative position limits may also be imposed, again under Rule 525A. This has not so far been used.
ICCH

(a) The minimum net worth requirement for General Clearing Members has been raised to $15 million by 31 March 1988 and $25 million by the year-end; the equivalent figures for Individual Clearing Members are $5 million and $10 million.

(b) It is proposed that associations or co-operatives should be able to acquire General Clearing Member status. As yet, none has.

(c) Margins are now collected on a gross basis. It has been indicated that original margin levels might be reduced once Clearing Members have increased their capital and position limits have been introduced.

(d) The number of open positions a General Clearing Member or Individual Clearing Member may hold is now limited in relation to its net worth.
APPENDIX 25

REGULATORY FRAMEWORK OF THE SECURITIES AND COMMODITY FUTURES INDUSTRIES IN HONG KONG

Introduction

Regulation of the securities and commodity futures industries in Hong Kong has its historical origins in the stock market boom and collapse of the early 1970's. Prior to 1974, the securities industry was only loosely regulated under the relevant provisions of the Companies Ordinance, the Stamp Ordinance and the Stock Exchange Control Ordinance. (1)

Legislation and rules

2. The business of dealing in securities and commodities futures and of giving advice thereon is basically governed by the following legislation and rules -

(a) Stock Exchanges Unification Ordinance, Cap. 361;
(b) Securities Ordinance, Cap. 333;
(c) Protection of Investors Ordinance, Cap. 335;
(d) Commodity Exchanges (Prohibition) Ordinance, Cap. 82;
(e) Commodities Trading Ordinance, Cap. 250;
(f) Companies Ordinance, Cap. 32; and
(g) Memorandum and Articles of Association as well as Rules (and Regulations) of -
   (i) the Stock Exchange Hong Kong Limited;
   (ii) the Hong Kong Futures Exchange Limited;

(1) This was enacted in 1973 to prevent the establishment of further stock exchanges in addition to the four exchanges which then existed.
(iii) ICCH (Hong Kong) Limited; and
(iv) the Hong Kong Futures Guarantee Corporation Limited.

In addition, there are regulations made pursuant to the above Ordinances governing specific issues like accounts and audit, investigations, etc.

Regulatory structure

3. These legislation and rules provide for the establishment of a three-tier regulatory structure for the prudential supervision of the securities and commodity futures industries, namely -

(a) the Securities Commission and the Commodities Trading Commission;
(b) the Commissioner for Securities and Commodities Trading and his Office; and
(c) the Stock Exchange of Hong Kong Limited, and the Hong Kong Futures Exchange Limited together with its clearing house and guarantee corporation.

A. The securities industry

The Securities Ordinance

4. The business of dealing in securities and of giving related investment advice has, since 1974, been regulated by the Securities Ordinance. This Ordinance is essentially based on the New South Wales Securities Industry Act 1970, which in turn evolved from the United States.

5. The main impetus for the promulgation of the Securities Ordinance came from the stock market boom and crash of the early 1970's and arose out of the 1971 Report of the Companies Law Revision Committee (CLRC). This drew heavily upon the Jenkins Committee Report in England and recommended, inter alia -

(a) the licensing of 'dealers, investment advisers and portfolio managers and their representatives;
(b) the establishment of a licensing authority i.e. the Commissioner for Securities, to be supported by his own staff;

(c) the establishment of a Securities Advisory Board to deal with appeals and conduct of business;

(d) some restrictions on the proliferation of stock exchanges;

(e) the establishment of a Compensation Fund; and

(f) various provisions relating to prospectuses, takeovers, mutual funds, unit trusts, etc.

6. The Securities Ordinance provides for the establishment of a Securities Commission and brings all stock exchanges under its supervision. It provides for the creation of a Commissioner for Securities as the executive arm of the Securities Commission and vests in the Commissioner certain direct powers, particularly in the registration of securities dealers and advisers. It requires dealers to keep proper accounts and records and empowers the Commissioner to appoint an auditor if necessary. It obliges the stock exchanges to provide funds to compensate persons who suffer from defalcations by stockbrokers. It confers powers of investigation on the Commissioner and on inspectors appointed by the Commission in relation to suspected or alleged fraud, etc. It seeks to protect investors by creating certain offences in relation to improper practices connected with dealings in securities, for example, hawking of securities, short selling and option and forward trading. It further provides that investors may be compensated in damages for losses occasioned by certain improper trading practices such as creating false markets. It also contains provisions for the inquiry into suspected insider dealing by an Insider Dealing Tribunal, though it does not make insider dealing an offence.

The Securities Commission

7. The Securities Commission was established in 1974 under the Securities Ordinance. It is a body corporate consisting of at least seven members including the Commissioner for Securities, the Registrar of Companies and other members drawn from the professions and the industry. All members, including the Chairman, are appointed by the Governor for a period of two years, subject to renewal.
8. The functions of the Commission, which are laid down in the Ordinance, include -

(a) to advise the Financial Secretary on all matters relating to securities;

(b) to apply the Securities Ordinance and the Protection of Investors Ordinance;

(c) to report any insider dealing cases to the Financial Secretary;

(d) to supervise the stock exchanges; and

(e) to protect investors and ensure fair practices prevail.

9. The Commission has five committees dealing respectively with -

(a) takeovers and mergers;

(b) the licensing of unit trusts;

(c) authorization of advertisements relating to paper gold schemes;

(d) Bills of Exchange and Certificates of Deposit; and

(e) investment-linked life assurance schemes and pooled provident funds.

Also, as laid down in the statute, the Commission has a Compensation Fund Committee and a Disciplinary Committee, each of which has two members nominated by the Stock Exchange of Hong Kong Limited (SEHK).

10. The constitution and rules of the SEHK, including any amendments thereto, have to be approved by the Commission. The Commission may, after consultation with the SEHK, make rules in respect of listing of securities, suspension of dealings, new offers of shares to the public, membership of the Exchange, etc.

11. Under the Securities Ordinance, the Governor may give directions to the Securities Commission or Commissioner in the exercise or performance of their powers, duties and functions. Furthermore, the Financial Secretary may require the Commission to furnish him with reports on current or proposed policy.

12. The Commission may withdraw recognition of the SEHK as the Exchange Company or may order suspension of trading under certain circumstances.
13. The Commissioner for Securities is a civil servant appointed by the Governor to "carry out the directions of the Commission in relation to the exercise of its functions" (S. 7 of the Securities Ordinance, q.v.). The Commissioner is therefore the executive arm of the Securities Commission. In addition, the Commissioner is given a wide range of statutory responsibilities in connexion with dealings in securities, in particular, the registration of dealers in securities, dealers' representatives, investment advisers and representatives of investment advisers. Furthermore, the Commissioner has the power to close the Exchange and to order a suspension of dealings on the Exchange.

The Stock Exchange of Hong Kong Limited

14. The Stock Exchanges Unification Ordinance (SEUO) was enacted in 1981 to provide for an exchange company to operate a unified stock exchange. The unified Stock Exchange, operated by the SEHK, came into being in 1986 on the amalgamation of Hong Kong's four previous exchanges. The Exchange is owned by its members and managed by a Committee elected by the members. The SEUO governs the relationship between the Commissioner for Securities and his Office, the Securities Commission and the Stock Exchange of Hong Kong Limited.

15. The SEUO governs the Memorandum and Articles of Association of the SEHK. It also provides that amendments to the Memorandum and Articles of Association or Rules of the SEHK must be approved in writing by the Securities Commission. While the Securities Commission has no power to direct the SEHK to amend its Memorandum and Articles of Association, it has the power to direct an amendment to the Rules of the SEHK. The SEUO sets out the Rules for minimum eligibility of individual and corporate members of the SEHK and confers powers on the SEHK to make Rules with regard to listing, capital requirements of members and other matters relating to the operation and management of the SEHK.

16. The Memorandum and Articles of Association of the SEHK provides for the regulation and conduct of the business of a stock exchange. The Articles of Association set out, inter alia, the provisions relating to eligibility for membership, the constitution and powers of the Committee of the Exchange and provisions dealing with the disqualified Committee members.

17. Pursuant to the SEUO and its Memorandum and Articles of Association, the SEHK has prescribed Rules to govern the official listing of securities on the Exchange.
and to regulate the administration of the Exchange. Rules have also been developed on membership, financial and accounting requirements by members, trading rules, code of conduct, disciplinary matters, payment of fees and charges, and compensation. These rules also provide for action to deal with any emergency.

18. New issues and offers to the public of shares, whether or not listed, are also subject to the prospectus registration requirements of the Companies Ordinance and the general restrictions of the Protection of Investors Ordinance on the making of invitations to the public with respect to securities and other investments.

B. The Commodity futures industry

The Commodities Trading Ordinance

19. The Commodity Exchange (Prohibition) Ordinance was enacted in 1973 to restrict the establishment and operation of commodity exchanges.

20. In 1976, the Commodities Trading Ordinance was promulgated to provide for the establishment of a commodity exchange and to control trading in commodity futures contracts.

21. The Ordinance provides for the establishment of a Commodities Trading Commission, and vests in the Governor-in-Council powers to license any company to establish and operate a Commodity Exchange. Such a licence was given to the Hong Kong Commodities Exchange Limited in 1977. The licence was renewed in 1984 when the Exchange Company was re constituted as the Hong Kong Futures Exchange Limited (HKFE) with Government-appointed membership of the Board of the Company.

22. The Ordinance also provides for the registration of commodity dealers, advisers, dealers' representatives and advisers' representatives. It requires dealers to keep proper accounts and records and empowers the Commissioner to appoint an auditor if necessary. It deals with the trading practices for specified commodities namely, cotton, sugar, soyabean, gold and Hang Seng index futures. It also seeks to protect investors by creating certain offences in relation to improper practices connected with dealing in commodities, for example, hawking of futures contracts and false trading. It provides for inquiries into allegations of misconduct on the HKFE, and obliges the HKFE to provide funds to compensate persons who suffer from defalcations by commodity futures brokers.
The Commodities Trading Commission

23. The Commodities Trading Commission was established in 1976 under the Commodities Trading Ordinance. Like the Securities Commission, it is a body corporate. The Commission consists of not less than seven members, including the Commissioner for Securities and the Chairman of the Securities Commission, who is automatically the Chairman. All members are appointed by the Governor for a period of two years, subject to renewal.

24. The functions of the Commission include -

(a) to advise the Financial Secretary on matters relating to commodity futures contracts;

(b) to enforce the Commodities Trading Ordinance;

(c) to supervise the activities of the Futures Exchange; and

(d) to protect those who trade in futures contracts.

25. The Commission has an Investigations Sub-committee to inquire into any report of irregularity or suspected irregularity by the Exchange Company or the Clearing House and may appoint a Disciplinary Committee to determine any allegation. That Committee also acts as an Appeals Committee to determine appeals against decisions of the Commissioner. The Commission also administers the statutory compensation fund through the Compensation Fund Committee.

26. The use of any clearing house and guarantee corporation by the HKFE has to be approved by the Commission. Also, the constitution and rules of these three bodies, including any amendments thereto, have to be approved by the Commission.

27. The Governor may give directions with respect to the exercise or performance by the Commodities Trading Commission or Commissioner of their powers, duties and functions under the Commodities Trading Ordinance and may direct closure of the Exchange in an emergency or crisis situation.

28. The Commission also has powers to close the Exchange and to revoke its licence to operate in certain circumstances.
The Commissioner of Commodities Trading

29. In addition to performing the specific functions conferred on him by the Securities Ordinance, the Commissioner for Securities is also the Commissioner for Commodities Trading under the Commodities Trading Ordinance. Although the Commodities Trading Ordinance does not say so in terms, the Commissioner for Commodities Trading operates as the executive arm of the Commodities Trading Commission.

30. The Office of the Commissioner for Securities and Commodities Trading, which is staffed by civil servants, is thus the primary executive agency for the prudential supervision of the securities and commodity futures industries in Hong Kong.

The Hong Kong Futures Exchange Limited

31. Like the SEHK, the HKFE comes under the supervision of the Commissioner's Office in his role as the Commissioner for Commodities Trading, under the direction of the Commodities Trading Commission. At present, the HKFE trades the Hang Seng index futures contract as well as futures contracts in gold, soyabean meal and sugar.

32. The Memorandum and Articles of Association of the HKFE establish a commodity exchange or exchanges in Hong Kong and provide for the management and control of the HKFE. The Articles of Association lay down the constitution and powers of the Board of the Exchange, and provides for the disqualification of Directors.

33. The HKFE has prescribed Rules and Regulations to govern the administration, membership, code of conduct and trading rules on each market conducted by the Exchange.

The ICCH (Hong Kong) Ltd. and the Hong Kong Futures Guarantee Corporation

34. In addition to the HKFE's Rules and Regulations, the ICCH (Hong Kong) Limited and the Hong Kong Futures Guarantee Corporation also lay down Rules governing the registration of contracts, payment of deposits and margins, security for deposits and margins, invoicing back, indemnification of members' liability and the like.
APPENDIX 26

PROPOSED POWERS OF THE SECURITIES COMMISSION

POWERS OVER INDIVIDUAL FIRMS

Licensing

. To require any relevant information from the applicant firm and also directly from any of its directors, controllers and managers;

. to require an applicant to provide an accountant's (or other expert's) report on information contained in or relevant to the application;

. to be able to take into account any matters concerning business related to the applicant or its controllers; and

. to obtain information from, and provide information to, other public bodies and financial supervisors, here and overseas.

Revocation, suspension, restrictions

. To revoke, suspend or impose restrictions on a licence; and

. to freeze the business.

Prudential requirements

. To set capital and liquidity rules;

. to set concentration limits and reporting triggers;

. to set margin requirements; and

. to set conduct of business rules (this should be used sparingly as the emphasis should be on codes).

Directions

. To give directions on the conduct of the business where necessary to protect investors.

New major shareholders

. To vet and give prior approval (or not) to proposed major new shareholders or controllers of dealing companies.
Information

. To require information, books and records from the licensed firms and to appoint an accountant to report on information provided. Such powers should be extended to related companies and parties; and

. to have a right of entry to obtain such information.

Investigations

. To appoint inspectors to report on the nature, conduct, ownership and control of the business. Again, such powers should be extended to related companies.

Applications to Court

. To apply for injunctions to freeze assets while an investigation is proceeding;

. to apply for an order requiring repayment of clients' moneys; and

. to apply for a winding up or bankruptcy order if a firm is insolvent or it would be just and equitable or in the interests of existing or prospective investors or in the public interest for a firm to be wound up.

POWERS OVER EXCHANGES AND CLEARING HOUSES (CH)

Constitution

. To revoke authorisation;

. to require information in connection with authorisation (in the case of new clearing houses etc);

. to approve changes in the Memorandum and Articles; and

. to direct changes in the Memorandum and Articles.

Governing body

. To ensure the election/appointment systems operate fairly;

. to ensure any independent members are genuinely independent;

. to ensure the "broadly based and representative" requirements are satisfied;
to ensure that all candidates/members are fit and proper to hold their respective positions; and

to approve the terms of reference and role of the chairman and chief executive.

Management

- To require changes in the day-to-day running of the Exchange/CH;

- to appoint Securities Commission officials or outside advisers to run the Exchange/CH in an emergency; and

- to exercise any of the powers of the Exchange/CH.

Operation

- To give directions on the management of the Exchange;

- to approve or direct changes in the rule books;

- to suspend trading in a particular security;

- to suspend or cancel an SEHK listing;

- to approve a new product or contract (e.g. a new futures contract or options); and

- to set Exchange/CH margin requirements.

Member surveillance

- To require information about members and to directly deal with problems in a member firm if remedial action is not undertaken by the Exchange/CH.

Surveillance of the Exchanges/CHs

- To conduct periodic and/or ad hoc reviews and investigations;

- to require any information relevant to such reviews; and

- to appoint accountants (or other independent experts) to review and report on a particular area (or areas) of the institutions operations, management etc.
APPENDIX 27

AUTHORISED SECURITIES INTERMEDIARIES
(as at end November 1987)

<table>
<thead>
<tr>
<th></th>
<th>Dealers</th>
<th>Advisers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered Intermediaries</td>
<td>1105</td>
<td>635</td>
</tr>
<tr>
<td>Representatives</td>
<td>2571</td>
<td>326</td>
</tr>
<tr>
<td>Exempt Intermediaries</td>
<td>245</td>
<td>16</td>
</tr>
</tbody>
</table>

A. Registered Dealers (1105) -

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Members of SEHK</th>
<th>Not Members of SEHK</th>
<th>Also registered as investment advisers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporations</td>
<td>171</td>
<td>83</td>
<td>88</td>
<td>62</td>
</tr>
<tr>
<td>Directors of corporations</td>
<td>265</td>
<td>0</td>
<td>265(^1)</td>
<td>82</td>
</tr>
<tr>
<td>Sole traders</td>
<td>608</td>
<td>594</td>
<td>14</td>
<td>11(^3)</td>
</tr>
<tr>
<td>Partners of partnerships(^2)</td>
<td>61</td>
<td>61</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1105(^4)</td>
<td>738</td>
<td>367</td>
<td>155</td>
</tr>
</tbody>
</table>

(1) 122 were directors of companies who were not SEHK members and 143 were directors of SEHK member companies.

(2) 30 registered dealing partnerships.

(3) Dealers trading as sole-proprietors who are also directors of registered advisory companies.

(4) Of the 1105 registered dealers, 82 were also registered commodity dealers.
B. Exempt Dealers (245) -

<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Licensed banks</td>
<td>103</td>
</tr>
<tr>
<td>Trustee companies</td>
<td>18</td>
</tr>
<tr>
<td>Licensed/registered DTCs</td>
<td>66</td>
</tr>
<tr>
<td>Unit trust managers</td>
<td>26</td>
</tr>
<tr>
<td>Others</td>
<td>32</td>
</tr>
</tbody>
</table>

Total 245

C. Registered Advisers (635) -

<table>
<thead>
<tr>
<th>Category</th>
<th>Registered advisers</th>
<th>Also dealers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies</td>
<td>249</td>
<td>62</td>
</tr>
<tr>
<td>Directors of companies</td>
<td>363</td>
<td>93 (7)</td>
</tr>
<tr>
<td>Sole traders</td>
<td>22</td>
<td>-</td>
</tr>
<tr>
<td>Partners of partnerships (5)(6)</td>
<td>1</td>
<td>-</td>
</tr>
</tbody>
</table>

Total 635 155

---

(5) There was one registered investment advisers partnership under s.49B.

(6) The one general partner is a corporation. There are other limited partners but they do not need to register.

(7) Including 82 directors who are also directors of registered advisory corporations and 11 who act as sole trader registered dealers.
D. Registered representatives

<table>
<thead>
<tr>
<th>Acting for</th>
<th>Dealers representatives</th>
<th>Advisers representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies</td>
<td>863</td>
<td>318</td>
</tr>
<tr>
<td>Partnerships</td>
<td>181</td>
<td>-</td>
</tr>
<tr>
<td>Sole traders</td>
<td>1527</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>2571</td>
<td>326</td>
</tr>
</tbody>
</table>

Source: Office of the Commissioner for Securities and Commodities Trading
APPENDIX 28

EXAMPLES OF CONDUCT OF BUSINESS RULES

(a) **Firm/customer relation rules :—**

(i) firms to know the personal and financial circumstances of their customers and to recommend only what is suitable;

(ii) customers to be fully informed of the risks involved in what is proposed;

(iii) best advice i.e. that the product recommended will meet the customer's needs no less advantageously than any other product; transacted at the best price quoted at the time of transaction;

(v) business to be conducted within the framework of a customer agreement;

(vi) firms to disclose material interests, commissions, rebates, product particulars etc to their customers;

(vii) proper advertisements; and

(viii) firms to provide contract notes, confirmation notes and periodic statements.

(b) **Firm's conduct rules :—**

(i) the dealer to be completely independent in execution and giving advice; or to disclose any constraints on the exercise of independent judgement such as relationships with the company concerned etc;

(ii) circumstances under which the aggregation of customers' orders is permitted and fair allocation of transactions between customers;

(iii) no dealing in advance of research recommendations and customer orders;
(iv) customers come first, i.e. subordination of firm's interests, including limitations on dealings by the firm, its officers and employees;

(v) records of relations with customers to be kept; and

(vi) protection for customers' assets, whether money or documents of title - i.e. segregation.
APPENDIX 29

ENQUIRIES AND COMPLAINTS RECEIVED BY THE OFFICE OF THE COMMISSIONER FOR SECURITIES AND COMMODITIES TRADING

(2 January 1987 to 19 March 1988)

<table>
<thead>
<tr>
<th>Period</th>
<th>Number</th>
<th>Monthly Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 January 87 - 31 July 87</td>
<td>149</td>
<td>21</td>
</tr>
<tr>
<td>1 August 87 - 16 October 87</td>
<td>122</td>
<td>49</td>
</tr>
<tr>
<td>19 October 87 - 24 December 87(^{(1)})</td>
<td>702</td>
<td>351</td>
</tr>
<tr>
<td>28 December 87 - 19 March 88(^{(2)})</td>
<td>37</td>
<td>15</td>
</tr>
</tbody>
</table>

In addition the OCS received 490 complaints lodged with the Office of the Members of the Executive and Legislative Council. All these complaints were in respect of the Hang Seng Index Futures contract; some had already been reported to the OCS.

(1) The high number of complaints was generated by the market crash. Of these, 217 were related to settlement of stock transactions, 223 were related to the futures contract and 201 were general and miscellaneous enquiries.

(2) The sharp decrease in the number of complaints reflected reduced turnover and activity on the Stock and Futures Exchanges.

Source: Office of the Commissioner for Securities and Commodities Trading
APPENDIX 30

LISTING MATTERS HANDLED BY
THE OFFICE OF THE COMMISSIONER FOR SECURITIES
(1983 to 1987)

(A)  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public offers</td>
<td>4</td>
<td>8</td>
<td>5</td>
<td>5</td>
<td>20</td>
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<tr>
<td>Placings</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Introductions</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td></td>
<td>7</td>
<td>10</td>
<td>5</td>
<td>8</td>
<td>40</td>
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</table>

(B)  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public offers</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Rights issues</td>
<td>5</td>
<td>5</td>
<td>13</td>
<td>14</td>
<td>35</td>
</tr>
<tr>
<td>Private placings</td>
<td>*</td>
<td>8</td>
<td>17</td>
<td>34</td>
<td>70</td>
</tr>
<tr>
<td>Capital reconstructions</td>
<td>*</td>
<td>9</td>
<td>12</td>
<td>6</td>
<td>16</td>
</tr>
<tr>
<td>Shell reactivations</td>
<td>2</td>
<td>2</td>
<td>12</td>
<td>15</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>24</td>
<td>55</td>
<td>69</td>
<td>150</td>
</tr>
</tbody>
</table>

* figures not kept.
### Administration of the Securities (Stock Exchange Listing) Rules introduced in February 1986

<table>
<thead>
<tr>
<th>Category</th>
<th>1986 (From 1.2.1986 to 31.12.1986)</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notifiable transactions</td>
<td>93</td>
<td>182</td>
</tr>
<tr>
<td>Applications for listing</td>
<td>35</td>
<td>116</td>
</tr>
<tr>
<td>Formal objection to listing</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Applications for waiver</td>
<td>28</td>
<td>32</td>
</tr>
<tr>
<td>Resumptions of trading, Suspensions and delistings</td>
<td>13</td>
<td>28</td>
</tr>
<tr>
<td>Direction of suspension</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>169</strong>*</td>
<td><strong>360</strong></td>
</tr>
</tbody>
</table>

*184 annualised.

Source: Office of the Commissioner for Securities and Commodities Trading
APPENDIX 31

PROPOSED ENTRY REQUIREMENT FOR SECOND MARKET

(a) A market capitalisation of $20 million to $50 million;

(b) Trading record of not less than two years;

(c) Shares offered to the public at the time of admission must be newly issued shares;

(d) Nature of business should preferably be industrial, commercial or service enterprises;

(e) Minimum public holdings should be 15% of the total issued capital; and

(f) Money raised should be used for the purposes of the business of the company.