Schenk, C.R. (2004) *Regulatory reform in an emerging stock market: the case of Hong Kong, 1945-86*. Financial History Review, 11 (2). pp. 139-163. ISSN 0968-5650

Financial History Review 11.2 (2004), pp. 139–63. © Cambridge University Press 2004
Printed in the United Kingdom DOI: 10.1017/S0968565004000113

Regulatory reform in an emerging stock market: the case of Hong Kong, 1945–86

CATHERINE R. SCHENK
University of Glasgow

By the end of the twentieth century, Hong Kong was widely recognised as one of the world's top five international financial centres. This status is usually attributed to the growth in global financial services from the 1970s, the acceleration of the East Asian 'miracle economies' at the same time and the opening of China to international trade and financial relations from 1978. Even in the 1960s, however, the banking sector of Hong Kong was the third largest in the world measured by the number of foreign bank branches, and the territory's banking activity is still the main source of its global status. The share market, in contrast, ranked only tenth in the world by market capitalisation in 2002. While international banks flocked to Hong Kong from the 1960s, the equity market was relatively underdeveloped. Historically, share trading had developed during the same period in the late nineteenth century as the banking system, but it failed to take a commanding position in the post-war growth in financial services. Instead, in common with emerging stock markets in Asia and elsewhere, the Hong Kong exchange tended to be used as a speculative outlet for both small and large investors. This led to wide fluctuations in prices throughout the post-war years. This paper explores how the uneven development of the regulatory environment contributed to the relatively weak and volatile nature of the stock exchange in Hong Kong.

Some features of the Stock Exchange of Hong Kong in the mid 1990s were already apparent in the 1960s. Property prices were highly influential, trading tended to be concentrated in a few shares, and manufacturing was not well represented among the companies quoted on the market. This meant that the stock market was susceptible to speculation because prices were tightly correlated to fluctuations in property prices in a way that exaggerated the impact of cyclical trends.[1] The small role played by equity markets in the industrialisation of Hong Kong also reflected the colony's industrial structure, which was based on small and medium-sized

[1] L. C. Chau, 'Foreign investment in the Hong Kong stock market', in *Foreign Investment in Asian Stock Markets*, United Nations (1996), pp. 19–21.

enterprises that resisted issuing equity because of a preference for family control. Furthermore, Hong Kong was unusually heavily banked for a developing economy with 86 licensed banks and 301 bank offices in 1965. Bank deposits as a proportion of GDP increased from 41 per cent in 1959 to 70 per cent by 1964. Bank credit was thus a ready alternative to equity finance for medium- and larger-scale industry.[2] The scope for the equity market might therefore have been constrained by Hong Kong's industrial organisation and the competitiveness of the banking system. Alternatively, the inadequacies of the equity market might have deterred manufacturers from using it as a source of capital.

Hong Kong has traditionally been viewed as a laissez-faire paradise for international finance. Certainly, the government made only reluctant and often limited interventions in the financial system until the mid 1960s. After this time, however, the state became increasingly active, regulating the banking system by introducing legislation aimed at preventing lending to companies in which directors had an interest, ensuring a diversified portfolio of assets and trying to consolidate the industry through a moratorium on new bank licences from 1965–72. Prudential supervision was also gradually built up, beginning with mandatory monthly reporting to a new banking commissioner from 1965. Interest rates, however, were left to self-regulation. While there were periodic limited crises caused mainly by the collapse of small banks, this combination of self-regulation and state regulation created over time a robust banking system.[3]

The stock exchange, in contrast, was characterised by self-regulation for much longer than the banking system. This article explores why the state's attitude to the equity market differed from that of the banking system and how this attitude affected the functioning of the market. The pattern of self-regulation, followed by crisis and then state intervention was evident in both the stock exchange and in the banking system, but the government was quicker to act in the latter case. The softer attitude of the government to the stock market can be explained by both ideological and practical considerations. Part of the answer lies in the different attitudes of the players in the market. The enthusiasm for reform from brokers was negatively correlated to the level of activity in the market and they strongly resisted government efforts to intervene, while the largest banks were consistently in favour of greater state regulation in their sector. Also, the need for the state to protect the consumer was seen as less pressing for the stock market than was the case for banking, which was considered a necessary part of saving and financial intermediation. The stock exchange, by contrast, was considered essentially a playground for the

[2] C. R. Schenk, 'Finance of Industry in Hong Kong 1950–70: a case of market failure?' *Business History* (forthcoming, 2004).

[3] For bank regulation see C. R. Schenk, 'Banking crises and the development of bank regulation in Hong Kong', *Australian Economic History Review*, 44 (2004) and C. R. Schenk, *Hong Kong as an International Financial Centre* (London, 2001), ch. 3.

wealthy and it was only when the boom of 1972/3 drew in a wide spectrum of the population that the state considered intervening. However, the process was uneven and delivered mixed results that left the system vulnerable to corruption.

Regulation of new issues and share trading, and the costs that governments face when enforcing regulations are issues that plague all active equity markets. In the post-war decades the London Stock Exchange, for example, also wrestled with the balance between self-regulation and government intervention, and with unification of various exchanges. The LSE operated an elaborate and effective system of self-regulation that forestalled government intervention, but the market was still susceptible to the failures of non-members. Moreover, R. C. Michie argues that, by the 1980s, the rules set by the LSE 'gradually stopped Stock Exchange members evolving in ways best suited to meet the needs of the investors they served and the markets they operated in'.[4] Self-regulation can thus be as stultifying as external regulation. In 1985 the UK government tried to resolve the tension between external and internal supervision by setting up a Securities Investment Board that included several officially sanctioned self-regulatory organisations. To some extent, therefore, Hong Kong was merely sharing the difficult path of other financial centres. The case of Hong Kong, however, also exhibits problems common in other emerging markets. Rules only developed after the volume of trading had accelerated on the basis of a small number of listings closely linked to other speculative asset markets. Practices of self-regulation that had developed over many decades in centres such as London had to be created much more quickly, and this pace provided opportunities for moral hazard. In Hong Kong, there were only limited internal checks and balances until the 1970s: there was inadequate disclosure on prospectuses for new companies, no limits on insider trading, no separation of jobbers and brokers, and brokers were free to trade on their own account as well as for their customers.

I

Share trading began in Hong Kong after the first Companies Ordinance of 1865, and was brought into an organised stock exchange in the mid 1880s.[5] By the start of the Second World War there were two exchanges; the Hong Kong Stock Exchange, and the Hong Kong Shareholders Association. Some trading took place during the war, and resumed unofficially soon after the Japanese surrender.[6] However, demand was low, the number of brokers was drastically reduced, and prices fluctuated widely on the black market, destroying investor confidence.

[4] R. C. Michie, *The London Stock Exchange; a History* (Oxford, 1999), p. 559.

[5] Parts of this section draw on Schenk, *Hong Kong*, pp. 107–14.

[6] Interview with Mr Francis R. Zimmern, member of the HKSE from its inception and chairman 1972–7, 14 November 1996. Hong Kong Stock Market History Project, Centre for Asian Studies, University of Hong Kong.

Before the war there was no regulation of the activities of share brokers and when the reopening of the markets was proposed, the Hongkong Bank approached the government to suggest that rules and regulations be introduced to govern the market.[7] In July 1945, J. H.Taggart in Hong Kong asserted that self-regulation had not been effective before the war, with members contravening the rules of the exchanges with impunity. A second problem was the 'lack of discrimination displayed in affording entree to a galaxy of impecunious and irresponsible individuals of decidedly questionable character'. He also alleged that brokers 'forced themselves on the Boards' of several companies and used the insider information they gained to profit personally. A third issue was that brokers traded on their own account as well as on behalf of their customers. These activities undermined the effectiveness of the equity market as a source of capital and as a sound investment for individuals. Moreover, shares changed hands informally without reregistration of the owner in order to evade stamp duty.

Morse passed Taggart's ideas on to D. M. MacDougall of the Hong Kong Planning Unit in London. At this time, however, the government had other pressing business associated with the reoccupation of the colony and the question of regulating the stock exchange was set aside. The postponement was also due to reluctance on the part of the Hong Kong government to intervene directly. In the view of N. L. Smith of the Hong Kong government, it was difficult for them to enforce ethical standards. This might be better done, he argued, through a professional institute or council rather than by regulation, although he agreed that 'I think there must exist some legal powers of control.'[8] This established self-regulation as the preferred regime.

To consolidate the market, the government and the exchanges decided in November 1946 to fulfil plans made in October 1939 to merge the two exchanges into the Hong Kong Stock Exchange (1947) Ltd. (hereafter HKSE), which opened for business in February 1947. Twenty-two dealers, predominantly Hong Kong Chinese, made up the initial membership of the new exchange, although there was provision for 60 members. By April the number had reached 54 brokers, with four applications pending. Brokers were required to be of British nationality or able to prove that they had resided in Hong Kong for at least five years. This allowed entry to British brokers from Shanghai but not to mainland Chinese brokers. Members continued to trade both for their clients and on their own accounts.

Brokerage commission was first set at 1 per cent of the gross value of the transaction, where it remained throughout the 1950s, except for a brief spell at 0.5 per cent during an increase in activity in the market from mid November 1947 until May 1948. Profits were not subject to capital gains tax, but transactions were subject to an

[7] Letter from J. H. Taggart to Arthur Morse (HSBC), 8 July 1945. Public Records Office, Hong Kong (hereafter HKRS) 211/2/22.

[8] Manuscript memo by N. L. Smith, 17 August 1945. HKRS 211/2/22.

ad valorem stamp duty of 0.2%, bringing the total cost of trading to 1.2 per cent. Prices were chalked up on large wooden trading boards where bid and offer prices were quoted on a 'first come first served' basis.

The atmosphere was frequently described as being like a gentlemen's club. A prominent broker at the time, Francis Zimmern, described how there was a bar for members and they could drink and eat in the trading hall. During periods of dull trading, brokers would play dice or escape the hall for a round of golf, particularly when the exchange was closed for trading on Wednesday afternoons to allow clerks to catch up on paperwork. This relaxed and cosy atmosphere reflected shallow trading and narrow markets.[9]

Figure 1 shows the amount of new capital raised on the HKSE. The listings were dominated by large enterprises, primarily located in the service sector rather than manufacturing, despite this being a period of rapid textile-based industrialisation in Hong Kong. Of the capital raised between 1958 and 1966, 43 per cent was by public utilities and a further 15 per cent by hotel, property and commercial enterprises. From 1954–65 just over HK$760 million of new capital was raised on the stock exchange. This compared with HK$4.9 billion in 1966–72.[10] From 1959–68 capital raised through the stock exchange amounted to less than 1 per cent of GDP. The stock exchange was not an important source of capital formation for Hong Kong's post-war industrialisation.

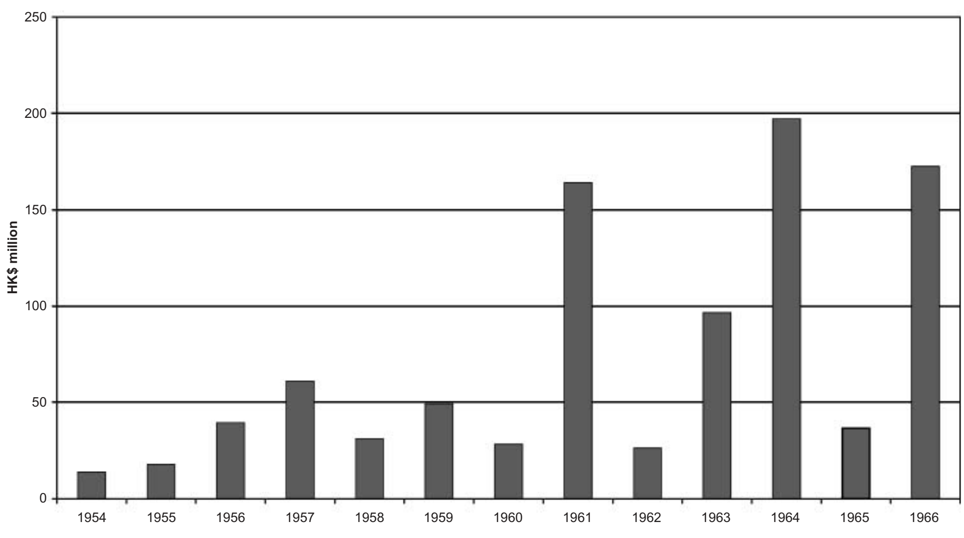

Figure 1. *New capital raised on the Hong Kong Stock Exchange*
Source: Y.C. Jao, *Banking and Currency in Hong Kong* (London, 1974).

[9] Interview with Zimmern.
[10] Y. C. Jao, *Banking and Currency in Hong Kong* (London, 1974), p. 88.

Table 1. *Companies listed on the HKSE, 1957 and 1967*

	Number of companies	
Industry group	*1957*	*1967*
Banking and finance	2	2
Insurance	3	2
Investment	3	4
Shipping	4	5
Other commercial	1	4
Docks and wharves	4	6
Utilities	5	8
Textiles	9	12
Other industrial	2	4
Stores	4	5
Miscellaneous	5	8
Rubber	4	4
Others	5	5
Total	51	69

Source: K. A. Wong, 'The Stock Market in Hong Kong: a Study of its Functions and Efficiency', Unpublished PhD thesis, University of Liverpool, 1975, p. 90.

Table 1 shows the number of companies listed in Hong Kong. Between 1957 and 1965, 19 new companies were listed and one insurance company was removed after it was taken over by a British firm. By the mid 1960s there was active trading in only 25 companies, with periodic trading in a further ten shares.

The narrowness of the Hong Kong market in this period can be attributed partly to the predominance of small family firms that depended primarily on internal funds or 'friendly' loans.[11] A further restriction on activity was that high unit prices for many shares tended to exclude all but the wealthy from participating in the stock market. In the 1940s, many investors were Chinese owners or managers of local banks, and brokers visited them daily to encourage business and deliver certificates.[12] In the 1950s, a few individuals such as George Marden (of Wheelock Marden and Co. Ltd), and Noel Croucher (a prosperous broker) had a large influence on the market.[13] Shares traded well above their par value, and were usually transferable only in collective 'boards' of minimum numbers.[14] For example, Hongkong Bank shares

[11] *Report of the Industrial Bank Committee* (Hong Kong, 1960), p. 5.

[12] Interview with Zimmern.

[13] *Shares in Hong Kong*, Hong Kong Stock Exchange, pp. 55–6.

[14] The 'Sticking List' which set the negotiable amount of shares for each listing was published in the *Far Eastern Economic Review* (hereafter *FEER*), 16 April 1947, p. 189.

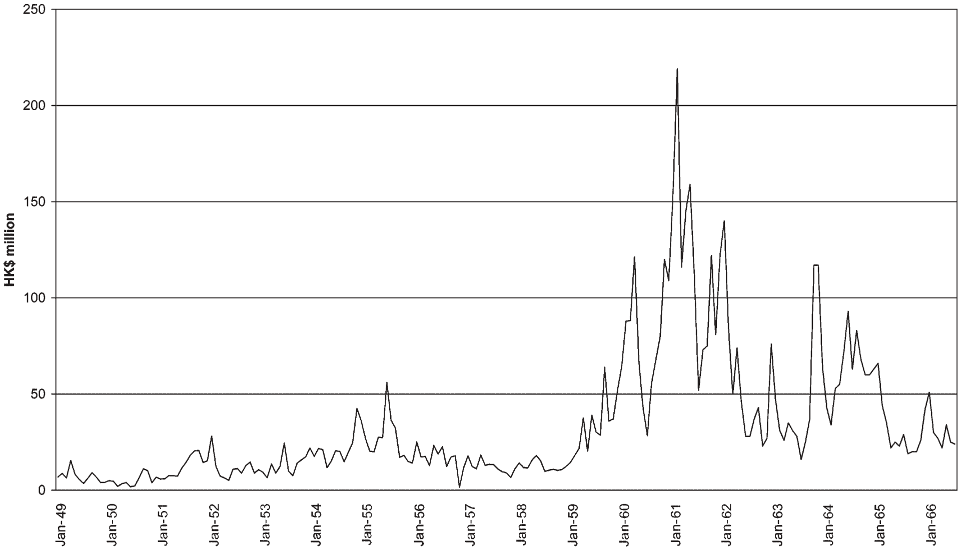

Figure 2. *Hong Kong Stock Exchange monthly turnover 1949–66*
Source: HKSE Weekly Share Report.

with a par value of $HK125 traded at over $HK1,450 (£90) in March 1961. At this point the shares were split in order to increase the popularity of the stock. By the end of the year, however, the price of these split shares had increased from $HK209 to $HK450.[15]

Figure 2 shows the monthly turnover on the Hong Kong Stock Exchange from 1949–66. Due to the relatively small number of new issues, the narrow range of investors in the 1950s, and the small number of public companies, the value of transactions on the market was fairly low until the boom of 1959–61.

The first post-war stock market 'boom' began in October 1959, partly due to inflows of capital from overseas. Investors were attracted to the shares of companies with large land holdings because property values had soared in the wake of local and overseas speculation. At the same time, the revival of international trade benefited the share value of banks and shipping companies.[16] The Hongkong Bank raised its overdraft rates for stockbrokers and borrowers against shares by 1 per cent in an effort to try to stem the speculation, but this had only a temporary dampening effect and turnover on the market recovered by February 1960. The monthly value of stock turnover reached its highest level in March 1961 at $HK219 million. Share prices on average doubled between 1959 and mid 1961, bringing dividend yields to

[15] 'Stock Market Report', *Hong Kong Exporter* (1962), pp. 89–93.
[16] Ibid.

levels similar to those of the US and Britain.[17] By June 1961 the cost of a seat on the HKSE had quadrupled to HK$200,000 (£12,500).[18]

In June 1961, the boom was halted by the failure of a local bank and by credit restrictions imposed to halt speculation. An official enquiry into the provision of electricity in the Colony recommended a merger of the two electric power companies, delivering a 'paralysing blow to confidence' to the market, knocking hundreds of millions of dollars off the value of utility shares within one week.[19] By August, market turnover had fallen to one quarter of the March value. Continued uncertainty about whether the government would adopt the enquiry's proposals, and periodic international political disturbances (including the Cuban missile crisis) depressed the market from mid 1962 until 1964. Once the utilities policy was resolved, the market recovered, but it was then struck by the banking crisis of 1965.

The *Far Eastern Economic Review* constructed an index of share prices based on the market value of shares of 20 prominent listed companies in August 1962.[20] Figure 3 shows the movements in this index from 1962–65. This shows the stagnation in prices during 1963 until the market recovered from the uncertainty described above. The banking crisis of April/May 1965 then resulted in a fall in prices to below the levels reached three years earlier.

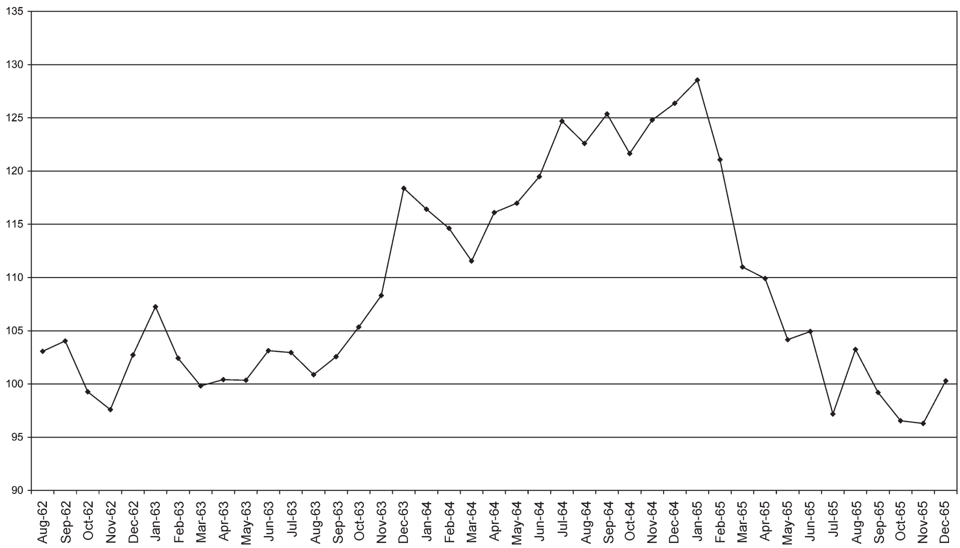

Figure 3. *Far Eastern Economic Review share index, 3 August 1962 = 100*
Source: Far Eastern Economic Review.

[17] K. A. Wong, 'The Stock Market in Hong Kong; a Study of its Functions and Efficiency', (Unpublished PhD thesis, University of Liverpool, 1975), pp. 83–4.

[18] *Shares in Hong Kong*, HKSE, pp. 57–8.

[19] *Nigel Ruscoe's Annual Hong Kong Register*, 1963, p. 207.

[20] For a list of the companies see *FEER*, 3 January 1963, p. 43.

In summary, the HKSE was forged in an environment of lax regulatory control reinforced by low turnover. The market was not an important contributor to capital formation, particularly for industry. Indeed, for 1959–64, the amount of new capital raised as a proportion of GDP was only about half that of the UK, USA and European stock markets. Moreover, from the early 1960s it was already apparent that the market was vulnerable to a variety of influences including fluctuations in property values, speculative momentum, local and international interest rates, and flows of capital in and out of the Colony. The government was not interested in intervening, however, as the market tended to be dominated by wealthy local investors and foreign capital. This profile was to change profoundly in the next decade.

II

A new era began in the late 1960s. Political agitation in the summer of 1967, associated with the Cultural Revolution in China, provided the second major shock to the market. Hong Kong communists organised a series of protests and riots that seemed to threaten the colonial integrity of Hong Kong. The exchange sought support from the government and large banks to sustain market prices but this was refused. Instead, trading was suspended for three weeks to prevent panic selling. With the successful confrontation of the communist agitators by the end of the year, however, political stability returned and in 1968 the market began to climb. The nominal value of turnover tripled from HK$305m in 1967 to HK$944m in 1968. This surge attracted a flood of new issues and rights issues of existing companies that totalled HK$321m in 1969, compared with only HK$29m in 1968.[21]

In this atmosphere of boom, with considerable profits to be made, Ronald Fook Shiu Li approached the HKSE and requested that the number of seats be increased to allow new entrants, but he was refused. In his frustration, Li and his associates decided to open their own exchange that would better serve the local Chinese community. It traded in smaller lots and used Cantonese as the lingua franca. Li, himself, had a reputation as a successful property developer as well as close connections in banking and financial circles, coming as he did from one of the most distinguished financial and business families in Hong Kong. He was the nephew of one of the founding members of the Bank of East Asia (the largest Hong Kong Chinese controlled bank in Hong Kong in the 1950s) and was a cousin of the chairman of the bank in the 1960s. The Bank of East Asia was famously conservative in its policy but Ronald Li seems to have been a more entrepreneurial character, having bought his first shares at age six in Hong Kong Electric and described by one of his relatives to the press as 'flashy'.[22]

[21] Jao, *Banking and Currency*.
[22] *FEER*, 28 March 1975.

The Far East Exchange (FEE) was planned with 34 seats available at an initial cost of $HK80,000, compared to $HK250,000 for a seat on the HKSE. In addition, 15 seats were reserved for the founders taking the total to 49. Some of the brokers were former members or runners for the HKSE. The response of the HKSE was initially hostile and brokers were not allowed to be members of more than one exchange, despite the fact that they traded in many of the same shares. The goal of the FEE, as reported in the press, was to encourage more new issues to broaden the range of shares available on the market as well as drawing in a wider range of investors. Li noted in 1975 that '[T]he old exchange was run like a club for the rich. I had an idea it could be popularised so the ordinary citizen could participate in the growth of the economy.'[23] He also asserted that companies were reluctant to go public because of the slowness of the HKSE in responding to applications.[24]

The new FEE at first did not comply with the conditions for recognising a stock exchange under the Companies Ordinance for 1970, but it was allowed to trade in the interim. The Ordinance required a compensation fund to be held against the risk of members in default. It also included a series of provisions to ensure transparency; that records of transactions be open to the public for a fee; that details of prospectuses should be disclosed, as well as the interests of a director of the FEE in any company to be listed. Li first applied for recognition in May 1970 but was only allowed interim recognition that was extended at three-month intervals until he had fully complied.[25] Finally, in September 1971, Haddon-Cave, the financial secretary, wrote to Li asking formally for assurance that the committee of the FEE were satisfied that their members abided by the rules. Li confirmed that members themselves were not trading on the margin, but that he could not vouch for their customers. [26] This satisfied the financial secretary and the FEE was officially recognized from the end of January 1971, over a year after it had started trading.

The establishment of the FEE challenged the gentleman's club atmosphere of the HKSE and was quickly followed by other exchanges.[27] At the beginning of 1970 the FEE asked the Gold and Silver Exchange to join, but they decided in May 1970 to open their own exchange, the Kam Ngan Stock Exchange (KNE), which started trading in the Tai Sang Bank Building in 1971.[28] The Kowloon Stock Exchange

[23] Quoted in *FEER*, 28 March 1975.

[24] *FEER*, 27 Nov 1969.

[25] Letter from financial secretary to the FEE, 29 April 1970, 9 January 1971, 30 March 1971. Archive of the Far East Exchange, University of Hong Kong (hereafter FEE) Box 32/1.

[26] Haddon-Cave to FEE, 13 September 1971. Reply from Li to Haddon-Cave 17 September 1971. Reply from Haddon-Cave to Li, 21 October 1971. FEE Box 32/1.

[27] The FEE and the KNE also broke with HKSE tradition by allowing women brokers to become members. *FEER* 25 December 1971.

[28] Minutes of the General Committee Meetings FEE, 28 January 1970 and 4 March 1970. FEE Box 81/4. For an account of the Gold and Silver Exchange see C. R. Schenk, 'The Hong Kong gold market and the Southeast Asian gold trade in the 1950s', *Modern Asian Studies*, 29 (1995), pp. 387–402.

(KSE) followed in January 1972 with 156 members and began trading in the shares of 99 companies. As well as trading the shares of the main bank and land companies, it specialised in listing smaller local companies and corporate shells, many of which could not meet the listing requirements on the other exchanges. It claimed to be the first exchange to use computers to generate daily reports and produce invoices.[29] Despite its name it was not located in the manufacturing centre of Kowloon but at Queens' Road Central in the financial district on Hong Kong Island near the other exchanges.

In February 1973 the government rushed through legislation preventing trading outside existing exchanges for fear that excessive competition in the market would be destabilising. Competition among the exchanges pushed brokers fees down when the market was sluggish and they were as low as 0.12-per cent on some share issues even before the KSE opened.[30] The KSE generally charged 0.25 per cent brokerage compared with the 0.5 per cent on most issues by the FEE and HKSE. They also charged less for a seat; $50,000 compared with $80,000 for the FEE. This raised fears that brokers would not be making sufficient money from their activities, might be driven to take excessive risks on their own account, and that they might be easily bankrupted.[31] The threat was accentuated in Hong Kong because there were no rules for the proportion of a placement that needed to be sold to the public. Brokers could thus retain all of their portion of a new issue in order to reap the profits of subsequent post-issue price rises. The government certainly believed that competition between the exchanges undermined standards of listing and trading.[32]

The FEE was immediately successful, suggesting there was indeed a pent-up demand for shares and desire among companies to go public. At the end of 1969, 75 companies were listed on the FEE. In 1971, 65 new listings appeared on the FEE and a further 56 the following year.[33] In 1971, the FEE accounted for only 23 per cent of the number of new listings, but this increased to 66 per cent in 1972 and 49 per cent in 1973.[34] The FEE was thus leading the new issues boom. Hang Lung Development Company was the first to apply for a simultaneous IPO on the HKSE, FEE and KNE in September 1972. The number of employees of the FEE increased from 14 in 1970 to 35 by 1973.

By the end of the boom in mid 1973 nearly 1000 brokers were active in the four markets, representing one broker for each 4000 of Hong Kong's residents. Table 2 shows the increase in membership of the exchanges during the boom. In 1973 the KNE doubled its accommodation to meet the needs of its 350 members by moving to a 14,000-square-foot hall in central Hong Kong.[35]

[29] *The Kowloon Stock Exchange Limited*, 1972.
[30] *FEER*, 13 November 1971.
[31] *FEER*, 25 December 1971.
[32] View of the securities commissioner, Uisdein Innes, reported in the FEER, 13 June 1980.
[33] *Far East Exchange Ltd Yearbook*, 1979.
[34] *Far East Exchange Ltd Yearbook*, 1973.
[35] *Kam Ngan Stock Exchange Ltd, 10th Anniversary 1971–1980*.

Table 2. *Number of members of the exchanges, 1972 and 1973*

	Mid 1972	*Mid 1973*
HKSE	71	129
FEE	198	341
KNE	91	350
KSE	156	171
Total	516	991

Source: Wong, 'Stock Market in Hong Kong', p. 362.

As in the early 1960s, the stock market boom of 1972–3 was driven by rising property prices. Companies engaged in property development or with substantial land such as docks, wharves and godowns experienced the greatest surge in prices during the boom. Figure 4 shows the classified index for the FEE with April 1971 = 1000. Land and construction prices rose the most, although docks, investment companies and commercial/industrial companies all outperformed the index as a whole.[36] The vulnerability of the stock exchange to volatility in the property

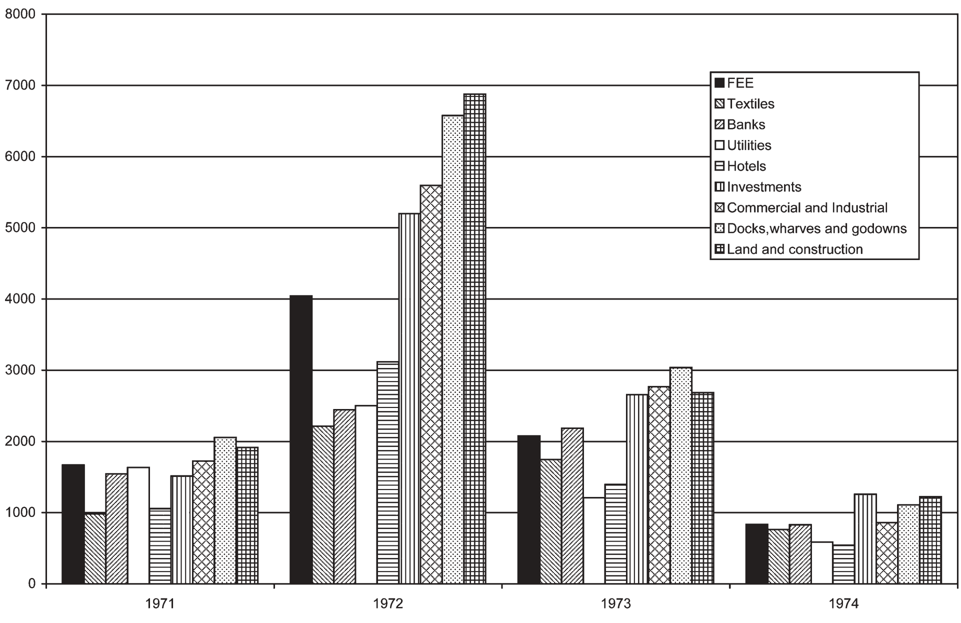

Figure 4. *Far East Exchange classified price index*
Source: FEE Annual Reports.

[36] The commercial/industrial index was comprised of the major merchant hongs such as Jardines, Hutchison, Swire Pacific and Wheelock as well as GI Cement, San Miguel, Lap Heng, Stelux and Zung Fu. 'Investments' included four investment companies. 'Land and construction' included 13 companies.

market continued throughout the exchanges' history. In 1995 about 50 per cent of the capitalisation of the local stock market was based on real estate.[37]

Land and construction companies comprised 14 out of the total of 80 companies listed on the FEE in 1971 (17.5 per cent), but this increased to 97 out of a total of 216 companies by the end of 1973 (45 per cent). The volume of turnover on the FEE was dominated by activity in this category of shares, which accounted for over 40 per cent of total turnover by volume from 1972–6, peaking during the boom at 62.2 per cent of volume. By value, however, property's share was considerably smaller as is shown in Table 3, which presents the two most active categories of shares by value and volume. These two categories accounted for over 60 per cent of turnover by volume and over 50 per cent by value. Unit costs for property shares were considerably lower than for commercial and industrial shares, suggesting that they appealed to the small speculator.

The speculative role of property in the boom is also clear in comparison of issue and market valuation. After the end of the boom, the market value of land and construction companies had fallen below the value of issued capital.

The new issues were designed specifically to appeal to the small investor. Of the 42 new listings on the FEE in the first 11 months of 1972, only one (Hang Seng Bank $HK100) had an offer price above $HK8 per share and half had an offer price of $HK1. Sixteen of these new issues were real-estate or property-development concerns. The market capitalisation of these 42 new listings was 75 per cent higher than the offer price by November 1972.[38] This pulled in other borrowers that hoped to cash in on the rising market. Barrie and Tricker note an example of the Hong Kong Backfire Loop Antenna Co. launched in 1972 on the KSE based on the sole asset of a patent on a TV aerial. The shares 'quickly shot up to 20 times their issue

Table 3. *Shares of the total turnover on the Far East Exchange, by sector, 1971–6*

	Land and construction		*Commercial and industrial*	
Per cent of total	*Volume*	*Value*	*Volume*	*Value*
1971	37.7	17.9	20.8	32.4
1972	41.3	26.5	15.0	31.6
1973	62.2	40.0	12.8	24.6
1974	43.8	26.4	25.5	32.0
1975	44.6	24.9	26.9	31.4
1976	42.5	26.6	19.5	25.6
Average	45.3	27.1	20.1	29.6

Source: *Far East Exchange Ltd Yearbook*, various issues.

[37] Chau, 'Foreign investment', p. 19.
[38] *Far East Exchange Ltd Yearbook*, 1972.

price'. Other examples included investment groups with very limited owned assets.[39] Ronald Li countered such criticism by claiming in 1972 that new companies listing on the FEE had assets that amounted on average to 94.6 per cent of issued price.[40] In December 1972 the Companies Ordinance was amended to require better disclosure on prospectuses.[41]

The share boom had repercussions in the banking sector. Bank loans to stock brokers increased sharply from $38m in March 1969 to $736m by the end of 1972, representing a growth in the share of total bank lending from 0.5 per cent to over 4 per cent. This increased commitment made banks nervous and, at the beginning of 1973, loans were called in, interest rates were increased, and the value of loans to stockbrokers fell back to 2.7 per cent of total loans by March 1973. The banks also took part directly in the boom. As noted above, in June 1972 Hang Seng Bank issued 100m shares at $100 each, which were 29 times oversubscribed and closed the day at $165. During the boom, bank shares had the highest ratio of market value to issued capital, peaking at 14:1 in 1972.

The boom was accompanied by an influx of merchant banks. In 1972, for example, James Slater of Slater Walker arrived from Singapore and 'set the market alight with a hectic series of deals'.[42] The Government had imposed a moratorium on new bank licenses from 1965, which was made official in 1967 and maintained until 1978 except for a brief hiatus in 1972–5 when Barclays Bank alone was allowed to enter. To evade the moratorium, over 2,000 local and overseas non-banking financial institutions opened to meet the demand for the services of merchant banks and finance companies. These so-called Deposit-Taking Companies did not come under the Banking Ordinance nor the self-regulatory interest rate agreement of commercial banks. The DTCs were left unregulated until a new Ordinance was enacted in 1976, after which their number dropped dramatically.[43]

The stock market boom was ended by a combination of tighter money, the end of the property boom, government warnings and discovery of fraudulent shares. On 11 January the Banking Commissioner asked banks to restrict loans using shares as collateral and the market turned downward. On this day the FEE was issued a citation by the fire officer to reduce the number of people in the exchange. In addition to 250 brokers on the floor, there were another 100 visitors and reporters in

[39] R. Barrie and G. Tricker, *Shares in Hong Kong: 100 Years of Stock Exchange Trading, Stock Exchange of Hong Kong Ltd* (Hong Kong, 1991), p. 78. An almost identical account is found in A. Rowley, *Asian Stockmarkets: the Inside Story* (Homewood, IL, 1987), p. 132.

[40] Chairman's Report, *Far East Exchange Ltd Yearbook*, 1972.

[41] Wong notes that until this time 'neither the disclosure of authorised, issued and paid-up capital was clearly stated, nor was the disclosure of the nature of the business, the purpose of the issue, or the consolidated accounts of an issue made by a holding company required'. Wong, 'Stock Market', p. 180.

[42] Barrie and Tricker, *Shares in Hong Kong*, p. 74.

[43] For the main features of the Ordinance see T. K. Ghose, *The Banking System of Hong Kong* (Singapore, 1987), pp. 80–2.

the public gallery, contributing to the spirit of the boom.[44] When the international monetary crisis raging in the rest of the world undermined confidence further, the stock exchanges restricted their trading to half days in February. At the end of the month, the banks increased interest rates, further dampening the market. In March, foreign exchange dealing was suspended in the wake of the collapse of the Bretton Woods fixed exchange rate system, and at the same time forged shares in Hopewell were discovered, sending shivers of fear through the market.[45] The biggest daily fall in the Far East Exchange index came on 4 April when the Inland Revenue proposed doubling the stamp duty on share dealings from 0.2 to 0.4 per cent, sending the FEE index down 9.7 per cent for the day (the Hang Seng Index fell 8.74 per cent). On 11 May, in order to forestall bankruptcies the FEE agreed to accept members' applications for loans using shares for collateral, one day after the KNE had announced the same.

Figure 5 shows price indices for three exchanges in Hong Kong and that of London adjusted for January 1973=100. It is clear when comparing London and Hong Kong that the surge in 1972/3 was the result of local factors. The Hang Seng index (based on the HKSE) moved very closely with the Far East Exchange. The Hang Seng index included 33 companies, only three of which were not

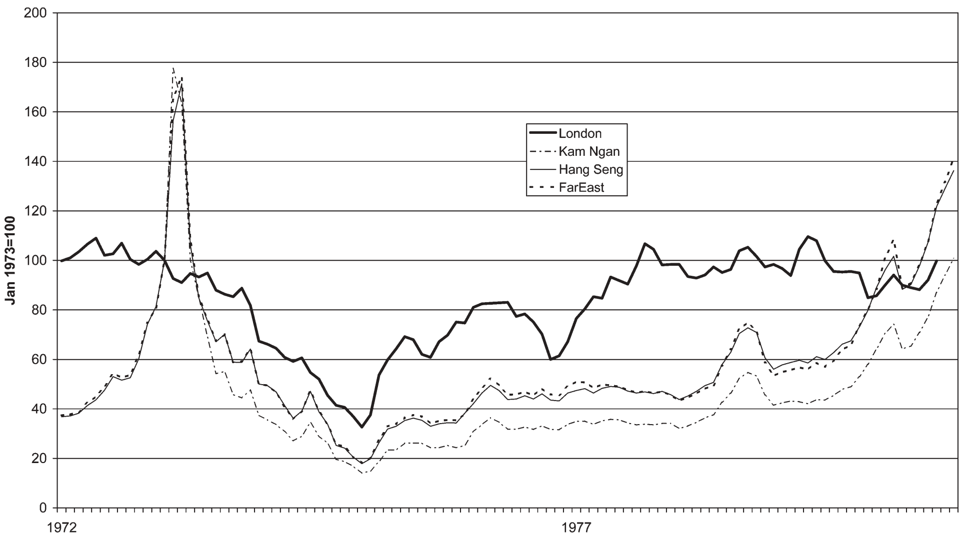

Figure 5. *Monthly Stock Exchange indices, 1972–80*
Source: FEE Annual Reports.

[44] Citation of fire officer, 11 January 1973. FEE Box 119/1. The *FEER* reported that the government had sent the firemen into the exchanges to curb speculative interest created by the crowds. *FEER* 19 February 1973.

[45] This was followed on 20 August 1973 by the discovery of forged Hutchison shares and in September by Lee Hing and Mei Hon and OOC forgeries.

included in the FEE index.[46] The Far East Index included 51 companies. The Kam Ngan index began at the start of 1973 and included 90 companies, of which 41 were not included in either the Hang Seng or the FEE index. They also published separate indices for 'new' and 'old' issues, believing that offering an index of 'new' shares provided extra information for its customers.[47]

Figure 6 shows that nominal turnover on the FEE peaked in 1972 while the other exchanges peaked a year later. The Hong Kong economy remained in a slump for three years as a result of the international economic crisis and this was reflected in the exchanges. After the slump the KNE turnover overtook the HKSE but the KSE never recovered from the bust of 1973. By 1975, equity trading was highly concentrated in a few shares: the top ten traded shares in the FEE by volume accounted for 59 per cent of total turnover. The ten most actively traded issues in terms of value accounted for 72 per cent of total trading value.[48] The ten largest companies accounted for over half of the total market capitalisation in 1975.

In sum, the boom of 1972/3 transformed the nature of the equity market in Hong Kong and posed new challenges. The proliferation of exchanges took place in a rapidly rising market and itself contributed to the new issue boom. Unlike the 1960s, the exchanges aimed new issues at the small investor and the phenomenal rise in

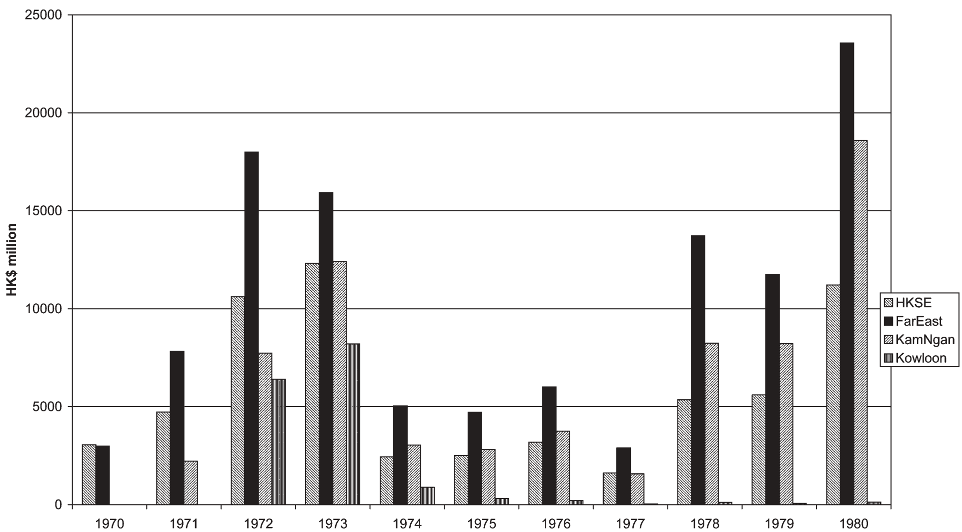

Figure 6. *Nominal turnover*
Source: FEE Yearbooks.

[46] PPK Ng, executive vice chair of the FEE asked Hang Seng Bank to include the FEE in the Hang Seng Index but this was refused on the basis that more than one index for similar stocks was confusing to investors. See correspondence March 1970 to April 1971. FEE Box 10/6.

[47] *Kam Ngan Stock Exchange Ltd Yearbook*, 1977.

[48] *Far East Exchange Yearbook*, 1975.

prices drew a wide spectrum of the population into the market. The government made a variety of efforts to stem the boom both directly and through the banking system, but its most decisive legal intervention was to introduce a moratorium on new exchanges. As in the banking system, their view was that excessive competition threatened the stability of the market by encouraging risky behaviour. The end of the exchange as a gentleman's club also opened the case for government intervention to protect the public from the widely publicised abuses of the system such as spurious floatations and fraudulent shares.

III

Hong Kong's financial secretary during the 1950s and 1960s, J. J. Cowperthwaite, was devoutly opposed to intervention in financial markets. This was particularly evident in his approach to bank regulation, but was also the case for the stock exchanges. Until the 1970s, the collection of stamp duty was the main intervention in the market. He finally retired in 1971, paving the way for supervisory regulation. In July 1971, when market trading was relatively low, the HKSE and the FEE tried to get the stamp duty reduced.[49] Because there were no jobbers in the market, brokers were sometimes left with transactions on their own account to cover. This arose from the delay between sales for overseas clients and arrival of the certificates, sales where certificates ended up having more shares than the sale, or brokers being asked to buy odd numbers of shares and having to take up the rest of the board lot themselves. The exchanges asked for a fixed charge on such jobbers' balances. Secondly, they asked for a 15 per cent allowance for mistakes since in Cantonese the word for 'buy' is very similar to 'sell'. Not surprisingly, both requests were turned down. The new financial secretary, Haddon-Cave, suggested using the Chinese words for 'in' and 'out' instead to avoid confusion.[50] In the boom in 1973 the government doubled the stamp duty to restrain activity in the market, reducing it again only in 1978.

As was the case for the banking sector, suppliers in the market hoped to enlist the government to support controls on competition.[51] In 1970, seven companies were formed to trade as stock exchanges. In July 1971, the FEE and HKSE jointly asked the government to prevent any new exchanges from actually opening, but they were turned down.[52] In August 1971 the Committee on the Reform of the Companies Law noted the need for some kind of supervisory 'watch dog' for

49 Letter from P. C. Woo on behalf of Far East Stock Exchange Ltd to financial secretary 30/7/71. HKRS 229/1/960.

50 Letter from Haddon-Cave to P. C. Woo, 17/11/71. HKRS 229/1/960.

51 On bank regulation in Hong Kong see Schenk, 'Banking crises'.

52 Letter from P. C. Woo on behalf of Far East Stock Exchange Ltd to financial secretary 30/7/71. HKRS. 229/1/960. The number of registered companies is from R. Fell, *Crisis and Change: the Maturing of Hong Kong's Financial Markets, 1981–1989* (London, 1992), pp. 38–9.

the stock market but recommended that there should not be any limit on the future number of exchanges and urged that self-regulation should be encouraged. They confirmed that 'we are fully convinced that Government should not get deeply involved in attempts to regulate and supervise stock exchanges.'[53] In September, Li suggested to the HKSE some joint action to stop the proposed fourth exchange (the KSE) but the HKSE decided that it was not politic to go ahead.[54] Noting that 'we have experienced enough difficulty with Government as it is', the committee of the HKSE decided not to go against government wishes on this matter. In their view, another exchange would not hurt existing ones beyond the proliferation itself damaging Hong Kong's reputation overseas.

Instead, the HKSE suggested that a Federation of Stock Exchanges be established along the lines of the British model to act as a self-regulating body and constrain competition.[55] The Federation would include a compensation fund, standardised brokerage fees and working hours, and rules for the registration of brokers. It would be chaired by each of the three exchanges in rotation. Share listings and placements would be made on the basis of the exchange that initiated the listing getting 50–70 per cent and the others sharing the rest. The listing fee would be doubled and shared out 50 per cent to the initiating exchange and 25 per cent to each of the others.[56] Ronald Li was initially not enthusiastic about linking the FEE to the more conservative HKSE practices.[57] However, he became more enthusiastic about constraining competition after the fourth exchange opened. The Kowloon Stock Exchange (KSE) closed 30 minutes later than the other exchanges, pioneered Saturday trading and charged only HK$8850 for a broker's seat, one-sixth of the cost on other exchanges. By May 1972, Li was doing the running on the proposed Federation, with the HKSE dragging its heels.[58] However, the proposal lay dormant through the market boom and bust of 1972/3 and the self-regulating Federation was not formed until July 1974.

In the meantime, the boom in share trading prompted the government to take more deliberate steps toward regulation. They had hoped that self-regulation would suffice, but the dubious nature of some of the new issues and the much wider pool of investors made the case for some government intervention to protect investors more compelling. During the boom, it was frequently observed that even servants were actively speculating on the market and the press regularly published photographs of long queues of poorly dressed punters waiting to submit applications

[53] Report of the Companies Law Revision Committee quoted in Fell, *Crisis*, p. 41.

[54] Letter from A. H. Potts, chair of HKSE to R. Li, 20 September 1971. FEE Box 112/9.

[55] Ibid. Michie describes the foundation of the Federation of Stock Exchanges in Great Britain and Ireland in 1965 as an unsuccessful step toward unification of exchanges by the LSE. Michie, *London*, pp. 459–60.

[56] Memo for Proposed Federation of Exchanges (draft), 12 April 1972. FEE Box 112/9.

[57] *FEER*, 30 October 1971, p. 49.

[58] Minutes of a General Committee Meeting, Far East Exchange, 19 May 1972. FEE Box 10/6.

for new issues. On 6 January 1973 the government established a Securities Advisory Committee to recommend regulations to protect investors similar to those of the proposed Federation, including standard brokers' commissions, and restricted membership of stock exchanges. There were no stock exchanges directly represented on the committee and it took nine months to produce a draft bill.

The end of the boom diminished both the market's and the government's determination to improve standards.[59] At the end of September 1973, the government finally published its new Securities Bill, but it was greeted with general opposition. Peter Chan, chair of the KSE 'claimed that brokers and exchanges should be self-regulating and that the bill would discourage honest men from becoming professional brokers'.[60] There were complaints about the proposed fund to which dealers were required to contribute cash to compensate investors who were misled by stockbrokers or who incurred losses from bankruptcy. As well as compensating investors, this fund was designed to weed out brokers without substantial means at their disposal. In response to protests, the government agreed to cut their initial recommendation for contributions of $HK100,000 (US$20,000) to $HK25,000 cash plus an equal guarantee from a bank. The government also retreated on the clauses outlawing insider trading. They were included in the bill but it was agreed that they would not be enforced until better definitions of insider trading were available. The draft bill banned short selling and forward trading as undesirable speculative elements in the market, but this was removed after protests partly on behalf of overseas investors. The Bill also recommended the establishment of a Federation of Exchanges that would undertake some self-regulation, along the lines of the HKSE idea.

In February 1974, the government introduced the Ordinance for the Protection of Investors and created the post of Securities Commissioner as a watch-dog. By the end of 1975, 1019 individual dealers (951 from the exchanges), 977 dealers' representatives, 60 investment representatives, 79 corporate dealers and 38 corporate investment advisors had registered with the commissioner.[61] Despite the pressures on the system exposed during the boom, however, self-regulation remained the cornerstone of the government's approach.

The institutional form of self-regulation was the Federation of Stock Exchanges, which was finally created in July 1974 (more than two years after it was first proposed) and dealt with training, research and standardisation. One of its decisions was to prevent foreigners from becoming full members of any of the exchanges in order to constrain competition. Overseas members were allowed only associate membership through a local broker, but the FEE ignored this decision in 1979 and again in 1980 by accepting overseas brokers as full members. The second time also

[59] When presenting his draft proposals to R. Li, Selwyn (securities commissioner) remarked that the need was no longer so pressing. Selwyn to Li, 17 September 1973. FEE Box 34/1.

[60] *FEER*, 22 Oct 1973, p. 62.

[61] Barrie and Tricker, *Shares in Hong Kong*, p. 85.

contravened the government's Unification Ordinance and exposed the weak enforcement of the Federation's guidance.[62] In August 1975, the government published the Code on Takeovers and Mergers, providing voluntary guidelines and requirements for companies to alert shareholders to such developments. Insider dealing was considered by a special tribunal in 1977 that decided that it should be the responsibility of the securities commissioner to investigate suspected cases rather than proposing more direct rules. By the end of the 1970s, therefore, the regulatory framework was still limited and voluntary.

In summary, self-regulation remained the preferred option for the government. As in the case of the banking legislation of 1965, the draft securities bill was considerably weakened as a result of negotiation with those who were to be regulated. The government did not feel it was possible to impose regulations on the market without compromise. In this case, self-regulation was a preferred option, both because the leading brokers were believed to know their business best, and because of the unwillingness of the state to develop a sophisticated bureaucracy that would be required to enforce prudential supervision on a reluctant market. Instead, a single commissioner was appointed with a small staff and, as was the case for the first banking legislation in 1947, his main role was limited to registration of members of the market rather than pro-active supervision. Instead of regulation, the government turned to consolidating the exchanges both in order to make it easier to perform prudential supervision and in accordance with its underlying view that the market was overcrowded by brokers. Their view was that this overcrowding threatened the integrity of the entire system.

IV

There was considerable rivalry among the exchanges, particularly between the HKSE and the FEE in its early days. There were also, however, strong forces for unification after the end of the boom. By September 1975, in view of the low level of business, it was agreed in principle that the exchanges should merge. At the beginning of 1976, J. B. Selwyn, the securities commissioner, wrote to the exchanges proposing that the way forward was to liquidate all existing exchanges and create a new one with the total number of seats set at about 300. This reflected his belief that the 1,000 brokers in business at the time were no longer supported by business on the market.[63] He suggested that the seats be allocated by inviting the top 500 brokers by size of turnover to bid for the 300 seats thus letting the market determine the price 'which is in conformity with the general atmosphere of Hong Kong'. Some compensation would be paid to those who gave up their seats. The exchanges, predictably, rejected this government initiative to reduce the

[62] Fell, *Crisis*, pp. 44–6. Fell's book is a personal account of his time as banking commissioner and securities commissioner in Hong Kong.

[63] Letter from J. B. Selwyn to Kam Ngan Stock Exchange, 15 January 1976. FEE Box 34/1.

number of traders so dramatically. Instead, a complicated network of bilateral negotiations began during 1977, a year which marked the lowest combined annual turnover on the exchanges during the 1970s.

Talks between Zimmern (now head of the HKSE) and Ronald Li took place secretly in March and April 1977. They met along with their deputies Mok Ying Kie and K. Wong on 12 April 1977 to propose a Hong Kong and Far East Stock Exchange Ltd with five council members from each and two co-chairs. This suggests the merger was more cosmetic than fundamental. The exchanges would communicate via CCTV, publish a single turnover figure and retain the Hang Seng index. The plan was to be put informally to members of both exchanges in a month, in time for an extraordinary general meeting to approve the proposals. Zimmern and Li hoped to arrange a merger agreement between their two exchanges that would then dominate the market and marginalise the smaller exchanges. But before their talks could bear fruit the HKSE Committee disrupted the negotiations and Zimmern resigned.[64] Instead, the Committee of the HKSE chose to begin negotiations with the KNE whose turnover was about the same as the HKSE, effectively ending the FEE/HKSE initiative.[65] On 26 April 1977, the same day as a press release from the securities commissioner urged the four exchanges to set up a merger working party, R. A. Witts, secretary and general manager of the HKSE told Li that he had spoken to the KNE and suggested a three-way merger.[66] The next day, the KSE reported to the securities commissioner that it had also received an invitation to consider merger from the HKSE.[67] In August 1977 the HKSE and the KNE were linked by closed-circuit TV to further integrate trading. Li described two possible models for unification; beginning with a merger of two exchanges that would then gradually absorb the others or the creation of a new exchange that would absorb all four exchanges. He preferred the former option as the easier path and, once rejected by the HKSE, approached the much smaller KSE, whose main asset was its premises.[68]

In May 1977, Li was in separate discussions with Peter Chan of the KSE about a possible merger.[69] The deal proposed by the KSE was that the FEE would acquire the KSE in return for 58 free seats for current KSE members. This represented one free seat for every three existing KSE seats. Those KSE members not participating would be compensated by $HK40,000 out of the sale of KSE assets. All companies listed only on the KSE would be persuaded to move or traded on a special board. No

[64] *FEER*, 96 no. 18, 6 May 1977, p. 60.

[65] On 6 April, Woo Hon-fai, chair of the Kam Ngan Exchange, wrote to Li on hearing of the merger talks between HKSE and FEE asking to be included. Letter from Woo Hon Fai to Li, 6 April 1977. FEE Box 58/11.

[66] Letter from R. A. Witts to R. Li, 26 April 1977. FEE box 58/11.

[67] Letter from P. P. F. Chan, KSE, to Securities Commission, 27 April 1977. FEE Box 58/11.

[68] Chairman's Report, *Far East Exchange Yearbook*, 1977.

[69] Letter from Peter P. F. Chan (KSE) to R. Li (FEE), 5 May 1977. FEE Box 10/6.

committee members of the KSE were to seek any office on the committee of the FEE, nor were the new seats transferable within three years in order to curb speculative occupancy of seats. In addition, the new KSE members would only need to put up $HK20,000 guarantee as opposed to the usual FEE guarantee of $HK250,000. The FEE countered that the KSE should begin by selling all assets and paying all the proceeds to the FEE in return for the 58 new FEE seats. The FEE would then pay the compensation of $HK40,000 to non-participants.[70] However, a multilateral working party on merger was established later in May 1977, which pre-empted these discussions. The correspondence, however, does suggest that while trading on the KSE was generally moribund by 1977, its fixed assets meant that it continued to be a player in the merger talks.

While the market continued to be in a slump, a working party was formed of two representatives from each exchange in May 1977. Echoing the driving force behind the market more generally, property and location were major considerations. The *Far Eastern Economic Review* reported that the 'Problems include physically combining the variously-leased exchange premises, reducing the number of brokers, and deciding how to compensate, from the exchanges' quite substantial assets, brokers that do not survive the thinning-out process.'[71] The discussions turned into wrangling as the market revived.

At the beginning of November 1977, the financial secretary made a public statement to the Society of Accountants setting out the reasons for the unification that suggested economies on both regulation and self-regulation. A single exchange would be more economic to administer, have a higher calibre secretariat to govern listing and disclosure, create a broader and less erratic market and make it easier to enforce legislation. He also warned that, unless tangible progress was forthcoming, he would legislate to achieve unification.[72] At the end of November 1977, after six months' deliberations, the working party promised a draft Memorandum of Association within two months. Peter Chan in the chair noted that 'I think it is imperative that we should convince the financial secretary that we are working as fast as we can in order that the future unified stock exchange will not be controlled in any way by the government.'[73] A draft memo was duly sent to Haddon-Cave in January 1978 and the target date for unification was set for the beginning of 1980.

Still, there were delays and further negotiation. The market recovered in mid 1978 and then accelerated from the third quarter of 1979. In the year from October 1979 to October 1980 the Hang Seng Index doubled from 600–1200. This return to prosperity reduced the incentive among the exchanges to merge and discussions

70 Letter R. Li to Peter P. F. Chan, FEE Box 10/6.

71 *FEER*, 29 Jul 1977, p. 50. These were also the obstacles described by Li in his chairman's report, *Far East Exchange Yearbook* 1977.

72 Letter from P. F. P. Chan to members of the Federation of Stock Exchanges, 8 November 1977. FEE Box 111/3.

73 Meeting of the Working Party for Unification, 28 November 1977. FEE Box 111/3.

became prolonged. Finally, having run out of patience, Haddon-Cave announced in his 1980 budget speech that the government would create a single exchange by law, and, in June 1980, the securities commissioner met with brokers to unveil the government's plans for an enforced merger. The rules for the unified exchange were devised by the existing exchanges but then had to be agreed by the securities commissioner before being passed into legislation. Brokers elected Woo Hon-fai, head of the KNE, to chair the committee on unifying the exchanges.

The 1980 Stock Exchanges Unification Ordinance had a strict timetable for a committee representing the four exchanges to select members and find premises with the expectation that the new exchange would begin trading in 1983. The inverse relationship between enthusiasm for reform and the level of activity in the market, however, prolonged the negotiations for a further three years. This time the reform was disrupted by a market boom and bust in 1980–2 that accompanied a prolonged currency crisis and banking crisis that dragged on to 1986. A major obstacle was satisfying existing members about the criteria for membership in the new exchange and this was only finally resolved in August 1985.[74] The new Stock Exchange of Hong Kong (SEHK) finally began trading in May 1986 with 900 members (600 more than the government had initially proposed) and was formally opened in October, just in time for the boom of 1986/7 that would bring about the fall of Ronald Li.

A new era for the Stock Exchange of Hong Kong was launched after the October 1987 crash required the suspension of trading for four days. In this instance, Hong Kong was mainly the victim of the global equities collapse, but the crash also exposed the poor governance of the market and the illegal practices that had arisen during the boom. Ronald Li, one of the most respected and influential participants in the market and founder of the FEE, was arrested by the Independent Commission Against Corruption in January 1988. He was convicted of soliciting and accepting preferential shares in return for approving new listings, and served two and a half years in prison.[75] This episode led to reform of the exchange to strengthen the regulatory framework and eliminate the 'ethical laxity' that had become endemic in the market.[76]

In 1988 the Davison Report delivered its recommendations for the reform of the SEHK in the wake of this scandal. It continued to promote self-regulation as the best course for Hong Kong. The report argued that this system offered flexibility, that the exchange had already 'taken substantial steps to put their houses in order', and that modern securities markets were too complex for outsiders to supervise effectively. The lack of skilled bureaucrats was noted as a particular impediment to

[74] Fell, *Crisis*, pp. 48–54.

[75] An account of the case is available on the ICAC website, www.icac.org.hk as one of the ICAC's landmark cases.

[76] This phrase is attributed to Nicholas Goodison, chairman of the London Stock Exchange, on a visit to Hong Kong in September 1987. Fell, *Crisis*, p. 224.

state regulation.[77] Instead, the external government watch-dog was strengthened by the establishment of a new Securities and Futures Commission with a more substantial staff and independent of government. The report also recommended that day-to-day management of the exchange not be left to its members and that professional managers should be introduced instead. The self-regulation was thus moved one step away from the members themselves in an effort to reduce moral hazard.

V

The case of the Hong Kong stock exchanges shows the problems inherent in relying on self-regulation with inadequate external supervision. When the market was small in the pre-war years and through the 1950s, the problems of insider trading and other forms of malpractice did not attract the interest of the government. Dominated by influential British expatriates, the HKSE operated an unregulated monopoly with the spirit of a gentleman's club for almost 25 years before competition entered the market. However, the monopoly was restraining the growth of the market by the late 1960s, as is evident in the explosion of business after the three other exchanges opened for business. Self-regulation without supervision in this highly competitive atmosphere made it much easier for companies to quote on the exchange and so raise capital, but it also led to the bidding downward of listing standards and the quality of brokers. Companies that did not meet the requirements of one exchange could merely move on to another while the fees for membership of the exchanges fell drastically. This generated costs for the stability of the market and for unwary small-scale investors that eventually drew the government in to constrain this competition by merging the exchanges. The monopoly SEHK, however, became the victim of corruption because self-regulation was not combined with effective external supervision and enforcement.

The weak supervisory structure for equity trading echoed the government's approach to the banking sector. As was the case for banking, it took a crisis and the need to protect the public to prompt reluctant government intervention. In the case of the banking system, the large and powerful banks persistently called for greater external regulation that they hoped would create barriers to entry and would eliminate excessively risky activities by smaller banks that threatened the stability of the system as a whole. Unlike the case of the equity market, the large domestic banks were advocates of state regulation and there were fewer opportunities for moral hazard because of greater transparency, particularly in the international sector. The large banks were conservative and risk-averse, while the leaders of the FEE, KSE and KNE were not. In the case of the banks, self-regulation was eventually limited to interest rates offered on deposits after 1965, while for the equity market the scope was much wider.

[77] Report of the Securities Review Committee (May 1988), ch. 3.

A free-market approach would suggest that competition would naturally force the weakest companies and corrupt brokers out of the market, but this proved to be a costly process that even the bust of 1973 did not accomplish. The enthusiasm for quick returns on a rising boom market proved to the state that some intervention was required in order to protect the public. In the 1970s, however, state intervention was uneven and became focused on constraining 'excessive' competition to deliver stability. Consolidating the market by favouring larger participants promised to discourage risky behaviour and make supervision easier. While in the 1960s the government believed Hong Kong to be 'over banked', so in the 1970s the colony was considered 'over brokered'. Unlike the banks, brokers preferred self-regulation to government control, but remained reluctant to introduce any reforms, particularly when profits were high. Cooperation among the exchanges was greatest during dull times in the market such as in the mid 1970s when the federation was formed and negotiations took place to merge the exchanges. The weakness of the self-regulating federation was exposed when it failed to enforce restrictions preventing competition from overseas brokers. In the end, the individual interests of the exchanges could not be reconciled and the government was forced to coerce them to unify. A monopoly was thus restored to the new Stock Exchange of Hong Kong but this quickly led to corruption when the gaps in the supervisory system allowed the exchange to be undermined by bribery. The Davison Report charged that 'an inside group treated the Exchange as a private club'.[78] This is very similar language to the charges Li made against the HKSE, but the growth of equity trading meant the consequences of this cosy environment were much greater in the 1980s than in the 1960s.

Author's address:
Department of Economic and Social History
University of Glasgow
4 University Gardens
Glasgow G12 8QQ
Scotland
c.schenk@socsci.gla.ac.uk

[78] Ibid., ch. 1.