During the initial market closure the government put together a $2 billion rescue package to save the futures market, where the stock market collapse had caused major defaults. The funds were used to settle claims by market participants against the Futures Clearing House of the day which proved incapable of honouring its obligations in the face of massive defaults.[13] After the second plunge in the market the government put pressure on the financial community to assist in putting together a further $2 billion facility. However, the second facility was never used.

The Hong Kong market closure shook the confidence of many international (and local) investors in the Hong Kong stock market. As a result of this debacle the government decided that it must take an active role in overseeing the overhaul of the Hong Kong market and its regulation in an attempt to regain international confidence. In November of that year, the Governor of Hong Kong set up the Securities Review Committee to investigate the underlying problems which had led to the debacle of October 1987 and to recommend changes.

Traditionally, regulation of the Hong Kong equity market had been very weak, as will be discussed. The Exchange (and its predecessors prior to 1986) was run, as famously commented in the Hay Davison Report in 1988 'like a private club' for the benefit of members 'rather than a public utility'[14] with a supervisory body (the Securities Commission) which was understaffed, underqualified and largely ignored by the Stock Exchange,[15] as was spectacularly demonstrated by the October 1987 market closure.

A new era of market regulation can be dated from the reforms following the recommendations of the Securities Review Committee. The Securities Review Committee (the 'Committee') was headed by Ian Hay Davison, former head of Lloyds of London, and included six local market practitioners. (These included the chairman and founder of Peregrine, Hong Kong's most successful local investment bank in the equity market in recent years).[16] The Committee released its report, 'The Operation and Regulation of the Hong Kong Securities Industry', in June of 1988 (the 'Report'). The recommendations of the Report were generally considered sound by market experts but there was widespread cynicism regarding the likely implementation of the more than 240 recommendations. It was generally considered at the time that while the committee was led by a highly competent outsider, the implementation of its recommendations were to be left to exactly those insiders who had allowed the market disaster to occur in the

13. For further details of the situation see Derivatives chapter, pp 391–393.
14. Hay Davison Report, op cit, p 3.
15. Hay Davison Report, ibid.
16. Committee members were: Ian Hay Davison, SL Chen, Wah-Sum Lau, Peter Poon, Charles Soo and Philip Tose.

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first place.[17] However, in the event, most of the Committee's key recommendations were implemented over 1988 and 1989.

Of all the changes effected following the recommendations of the Committee the establishment of the SFC in 1989 as market regulator, replacing the earlier Securities Commission and the Commodities Trading Commission, was probably the single most important. Until 1991 the SFC was mainly active in carrying out changes recommended in the Committee's report. The outgoing head of the SFC in 1994 commented that the SFC having addressed all but three of the Committee's recommendations could now for the first time truly turn its focus to the future.[18]

The profound influence of the Report on the development of the local stock market both in the primary and secondary markets is unparalleled. Perhaps the greatest concern of the Committee was that the market, which was intended to be self regulatory, had not developed any true self regulation or self discipline at all. The staff of the Exchange were seen as ineffective and totally under the thumb of the committee of stockbrokers running the Exchange.

The regulatory bodies which were supposedly empowered to oversee the work of the Exchange and the Hong Kong Futures Exchange, the Securities Commission and the Commodities Trading Commission, were seen as directionless and reactive. The 24-hour payment system in operation in the Hong Kong stock market was clearly no longer able to function under the weight of market activity and was singled out as a matter of particular concern by the Committee, being observed mainly in the breach. This system had led to a major back up of orders as the market fell in October 1987 and had probably added to the general investor panic.

The fundamental recommendations of the Committee were:

- Revision of the structure of the two exchanges. The SEHK should have proper representation for its full membership on the governing body and a properly independent executive staffed by professionals.
- A three-day clearing system, properly enforced, and conversion to a central clearing system as soon as possible.
- The Hong Kong Futures Exchange should have a strengthened risk management system with a guarantee arrangement backed by a fund funded by clearing members.
- A strong independent statutory body staffed outside the civil service, funded mostly by the market, to oversee the market. This body should maintain market integrity and ensure that the exchanges undertake their self regulatory tasks properly. Such a body should have 'extensive reserve powers to intervene if they fall down on

17. *Far Eastern Economic Review (FEER)*, 16 June 1988, p 127.
18. SEHK, *Securities Journal*, July 1994, p 40, Interview with Robert Nottle.

If there is to be no placement there is no such draft of the prospectus circulated.[72]

Publicity

In the process of a new listing, as at most times in the life of a listed company, the dissemination of material information is a sensitive matter. Once a company has submitted its A1 form the publicity released by the company falls within the ambit of the SEHK Listing Rules. While the company may continue to release general information on its activities, it is not expected to make any kind of statement with regard to its planned fundraising amount, its proposed share price or its future prospects. Any material circulated which mentions the proposed listing before the hearing has taken place must clearly state that approval for a listing is being sought. Indeed, no information which the Exchange would consider to be 'price sensitive' is to be released at this period. The intention of this regulation, as with most regulations controlling the behaviour of companies which have listed, or are about to list, is to protect potential investors from information which might mislead. The sponsor will generally advise the issuer on these matters and the public relations company working for the listing candidate will try to influence media coverage at this point, trying to ensure that no embargoed information is released and that the press coverage of the company's general activities is as positive and as high profile as possible.

As soon as the hearing has taken place and the listing is formally cleared to begin, the company may make statements in the press regarding the proposed size and structure of the deal and red herrings will be distributed to the syndicate members who will then circulate them to their investor clients. Active public briefings will now begin.

Compared with the US market where publicity of any kind on a company to be listed is viewed with the utmost seriousness by the US securities regulator, the Securities and Exchange Commission (SEC), the Hong Kong market is relatively relaxed on the point of publicity. The Exchange maintains the right to disallow the listing of a company which permits price sensitive information to be leaked prior to the syndication of the deal, after the hearing. Nevertheless, it does occur from time to time in the Hong Kong market that newly listing companies are reprimanded by the Exchange for leaking information to the press on matters such as future business prospects.

This problem was particularly noticeable in the market in 1992/1993 with the first 'H' share issues. Flattered management teams of 'H' share companies in China chatted amicably with Hong Kong

72. In this case, the final document in its last draft form will be circulated to sub-underwriters, this is known as the U-proof.

newspaper reporters who had sought them out, giving extensive information and personal views on matters from the future business prospects of their companies to planned sizes of the share issues. In one case, a large centrefold article in the Sunday Money section of the SCMP gave full details of many plans of a listing company just days before formal listing hearings were to be held. In such cases the Exchange was firm in its condemnation but none of the 'H' share listings were disallowed on these grounds. Indeed, the Exchange has become less aggressive in its stand on this matter in recent years, making its reprimands very mild in many cases. This is put down, by market practitioners, to the fact that the Exchange itself is less than totally decided as to exactly what information should and should not be released.

Syndication

Before the hearing date, the lead underwriter of the syndicate, known as the bookrunner, (generally the brokerage arm of the sponsor) will begin the process of syndication of the deal. In the weeks before the formal hearing takes place the lead underwriter will approach (and be approached by) potential underwriters in the market. Usually a few days before the formal application (form C1) has been submitted for listing, the bookrunner will formally invite the larger underwriters into the transaction. While detailed written information on the listing is still not available to prospective syndicate members, basic information will be provided and meetings between the management of the company and the research analysts of prospective syndicate members will be arranged, if required. If the transaction is a large one expected to be placed with institutional investors, this pre-syndication stage is particularly important as the major underwriters will be expected to write research on the issuer to assist in the placement process and need both the time and access to the company to enable them to do this.[73]

As in the bond markets there is always a considerable amount of mutual back scratching in the syndication of equity issues. Merchant bankers will invite each other into their deals to ensure reciprocal invitations into other deals in the future. However, there is always at least a nominal exercise of consulting the issuer as to its wishes on the syndicate make up. The strength and sophistication of the issuer will determine the level of input it will have in this process. In general, it is in the interests of both the lead underwriter and the issuer to invite into a syndicate institutions who are able to attract as large and diverse a group of investors as possible, particularly

73. In practice these syndicates often fall into two groups, those, mainly larger houses, which will provide research support and those which will not. It is obviously the former group which need the earliest invitations.

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The first insider dealing case to be successfully punished under the new tribunal closed in July 1994 in the case of Success Holdings where the guilty parties were fined $1.23 million for an incident in which they made a profit of approximately $264,000. The second successful case, Public International Investments Limited, closed in September of 1995 with the perpetrators receiving fines of $3.88 million or five times their profits from the trades.[133] However, there was only provision for one case to be heard at any one time which was causing a back-up of cases and could potentially undermine much of the good that the successes had done in cleaning up the market. To deal with this problem, at the end of 1995, the tribunal was reorganised so two cases could be heard simultaneously. By the end of 1996 the fifth case was being heard and at least eight cases were waiting to go before the tribunals. With all cases to date successfully upholding the guilt of the accused parties, the SFC is extremely optimistic about the potential for the tribunals. However, with so few cases having gone before the tribunals it is, perhaps, still too early to say whether the use of the tribunals will be successful in Hong Kong, or indeed whether the success rate of the regulators will be higher than that in other markets.

In New York, where insider trading is vigorously prosecuted, the success rate is somewhere around 10%.[134] The major difference between the tribunal and a court of law in a common law jurisdiction is that in a court of law the accused is assumed innocent until proven guilty, with the burden of proof on the prosecutor. At the Insider Dealing Tribunal the burden of proof is clearly with the accused, removing the protection for the accused which underlies all judicial process in a common law jurisdiction. If the success of the tribunal continues it might be seen as a more effective tool against insider trading in this market than the use of the criminal deterrent. Should the tribunal be seen as either weak or vascillating, however, or if the backlog of cases becomes overwhelming, pressure will undoubtedly build once again for insider dealing regulation to become closer to that of the other major international financial centres.

Trading abuses

One of the persistent problems with any floor-based stock exchange is the trading abuses which can occur. One such abuse is known as 'rat trading'. Rat trading is the practice whereby a floor trader, working for a broker who receives a major stock order at a certain price, will wait to execute the order if he believes the price of the share in

133. SFC, Annual Report 1996. This number included the disgorging of the original gains, a penalty of 2.3 times the value of the gains and costs.
134. SEHK, *Securities Journal*, September 1991.

the market will drop. If the price does fall he will buy the shares at a lower price during the day through a nominee account of his own. He will then sell the shares back to the client's account later in the day at the higher order price and pocket the difference between the two prices. The local press would have us believe that such practices have been widespread in the Hong Kong market, particularly at the larger brokerage houses dealing in this market and that some of the small brokerages on the Exchange actually offered what were effectively rat trading facilities to floor traders from larger firms.[135]

In a 'sweep' of the market in early 1995 the SFC identified several cases of rat trading. In February 1995, July 1995 and March 1996 the major houses of James Capel (owned by HSBC markets), Standard Chartered and Jardine Fleming, respectively, all had rat trading unearthed in the ranks of their floor traders and all had the traders concerned fired. Since the introduction of the AMS system such practices are very much easier to track than in a floor-based trading system so that this practice can be expected to die away naturally as the market becomes more automated.

Front running is another major trading abuse which is extremely hard to trace in markets like Hong Kong which are not fully automated. Front running is a practice among some floor traders working for major brokerages where they receive, or are expecting to receive, a major 'buy' order from a fund manager client. Before the large client trade occurs the trader buys the share himself through a nominee account. The shares can then be sold at a profit as soon as the client order is actually placed and the market price rises. The SFC would claim that everything possible is done in Hong Kong to prevent such practices. However, without automated, online trades they are almost impossible to detect.

Share price manipulation is another matter of concern both to the SFC and the informed investing public, not to mention the popular press. Share price manipulation would generally refer to manipulation of the share price of a company by the major shareholder in order to benefit themselves at the expense of the minority shareholders. In a market with smaller listed companies and major shareholders controlling 75% of the shares and the minimum public float of 25%, often thinly traded, share price manipulation can obviously be arranged more easily than in larger, deeper markets with more diverse shareholding patterns. Share price manipulations can take many forms. In early 1996 the local powerhouse among investment banks, Peregrine, in which Li Ka Shing of Cheung Kong has shares, wrote a 'sell' recommendation on the shares of Chueng Kong. When the share price subsequently dropped Li Ka Shing bought heavily. Certain quarters

135. *SCMP*, Business Post, 18 February 1995, and 23 March 1996.

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CHAPTER 3

The Bond Market

I. INTRODUCTION

Significance of the bond market

In the US and Europe, the bond market might be said to represent the heart of the financial markets. Bond issues are one of the main sources of capital in those economies. Any mention of investment banking or merchant banking in the US and Europe generally brings to mind the activity of the bond markets.

By contrast, in Asia the bond markets remain a rather sickly cousin of the generally hale and hearty stock markets and the ubiquitous bank lending market. However, all parties involved in Asia's financial markets seem to agree that the bond markets do and indeed, must, have a role to play in the economic and financial development of the region. Merchant banks, from the local houses like Peregrine to the major international houses like Goldman Sachs, have vacillated between ignoring the market and stressing its great importance.[1] Since 1994 these two houses along with most investment banks with serious pretensions in the Asia Pacific region have been putting increasingly larger numbers of people and resources into the development of the bond business. The developments in the Hong Kong bond market have been impressive since 1990, but like all other bond markets in Asia the market in Hong Kong still has far to go before it can be considered a key financial market or before it provides a significant source of corporate fundraising.

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Characteristics of bonds

A bond is a transferable instrument which is an acknowledgment of debt and of the obligation to pay interest and repay principal by a borrower to holders of the bond. Bond issuers may be corporates, sovereign governments or supranational organisations such as the World Bank. Bond holders may be institutions or individuals. They

1. Peregrine set up a Fixed Income Division for the first time in the mid 1990s. Goldman, having closed its bond business in Hong Kong in the early 1990s, appears to have been stressing the business since 1994.

are creditors, who have priority for repayment over common and preferred stockholders.

Ownership of a bond may be evidenced either by a physical bond certificate (known as an 'immobilised' instrument) or through a computer book entry system (known as a 'dematerialised' instrument) where individual owners are recorded but do not take physical delivery. A bond may be a negotiable bearer instrument or a registered instrument. A negotiable instrument is one where ownership and good title is passed to a buyer who buys in good faith, regardless of whether the seller actually held good title. The ownership of such instruments may, therefore, be freely transferred with no notification to third parties. Bonds which are registered instruments are those whose ownership must be recorded in a central register before a new owner has legal title. Many national bond markets, such as the US, require bonds to be registered. Hong Kong, however, does not. Most international 'Eurobonds' are bearer instruments. Registered bonds make investment income easier for tax authorities to track; therefore, bearer bonds are attractive for the anonymity they provide to investors.

The term 'bond' can be used very loosely in referring to any transferable debt instrument. The term will be used in its broadest sense in this chapter. In the strictest definition of the word, a bond is normally designated as a fixed interest transferable debt instrument with a final maturity over ten years. Transferable instruments of a maturity under one year are 'bills' and those with a maturity of one to ten years are 'notes'. Bonds which carry a floating rate of interest are generally known as floating rate notes (FRN) even if their maturity is beyond ten years.

Bond prices and interest rates

A fixed interest bond is issued with a fixed coupon or interest rate on the date of issue. While this coupon does not usually (other than on especially structured bonds, to be discussed later) change during the life of the bond, the effective yield on the instrument, to buyers of the bond in the secondary market, will change as the market interest rates move. The bond will be sold at a premium if market interest rates drop after it is issued (reducing effective yields to buyers below the coupon rate) or sold at a discount to the original price if market interest rates rise after it is issued (thus increasing the effective yield to buyers above the original coupon rate). Buyers of bonds in the secondary market will, therefore, receive the market interest rate regardless of the coupon rate on the bond. By the same token, holders of fixed rate bonds take the risk that if they wish to sell the bond in the secondary market (rather than waiting to maturity and being repaid by the issuer) they will take a loss on the principal of the bond if interest rates have risen. A brief outline of bond price calculations is set out below.

The third, and probably strongest argument put forward to explain the problems of this market is the nature of the investors. While there are large pools of funds in Asia looking for bond investments in US$ and other eurocurrencies, these funds generally fall into two categories, the commercial banks which generally only take floating rate investments[85] and Central Banks, investing national foreign currency reserves, which are generally constrained in the bond paper they can buy. Most central banks only buy other sovereign or supranational organisations' bond issues. So, as with all the other segments of the Asian bond markets, the problem appears to come down to the same basic issue of the narrow investor base.

The Dragon bond market may fade away and prove a fad of limited life like others before it. It may die because of lack of proper local clearing, or investment from international financiers. However, given the overwhelming logic for such a market to exist it seems more likely that the Dragon bond may prove to be an idea a little ahead of its time which will at some point return as a real market. This will most probably only happen after the local bond markets have developed to a level of maturity where there is true diversity of local Asian bond investors and real strength among local financial institutions. This would propel the business forward without the level of outside help presently seen and provide the resolve needed to address such major issues as local clearing.

In financial markets where globalisation is the buzzword and 24-hour trading the norm, it seems almost contrarian, and decidedly parochial, to be discussing the importance of a discreet regional market. However, in this regard the comments of the Treasurer of the World Bank, Gary Perlin, seem to be particularly apt. Perlin points out that while the capital markets of today can be said to be truly global, with cross border capital flows of US$1.5 trillion per annum, (having grown at 50% per annum over the early 1990s) the investment markets can be said to be regional. While money may move all over the globe, investors invest very much by geography. Investors diversify their risk not only by different investment instruments and issuers but by allocating their portfolios to different areas of the world.[86] As long as investors differentiate the regions in which they wish to invest it would appear that there is still a need for a differentiated Dragon bond market in Asia.

One interesting development in the Dragon bond market is the potential for a greater Asian currency component as local currencies

85. As mentioned before, this is due to the fact that bank balance sheets are all funded on a floating rate basis and bank loans are all priced at floating interest rates.
86. Address to Euromoney Forum Hong Kong, 3 December 1996. Mr Perlin was discussing the markets in general and was not specifically referring to the Dragon bond market.

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become more international and consequently develop currency swap markets which can be used by international issuers. If currencies such as the New Taiwan dollar, the Singapore dollar, the Philippine Peso and even the Korean Won start to join the HK$ as currencies for international issuers this can be expected to have an effect on the development of an Asian currency market, or a Dragon bond market with a somewhat different flavour.

Hong Kong government

The Hong Kong government, unlike many other governments in the South East Asian region, has not to date been an issuer in the eurodollar market. With fiscal reserves which have been growing steadily since the 1980s there has been no need for the government to access this market.

The MTRC, the government owned corporation which is generally considered the proxy for a Hong Kong government issuer, has had a number of successful issues in the euromarket starting with a US$ FRN in 1984 and including an ECU 50 million issue in 1985 and a Canadian dollar issue in 1988. However, the MTRC has not, to date, issued in the Dragon market.

V. FOREIGN ONSHORE BOND ISSUES

Hong Kong corporates issuing in foreign markets

Most major domestic bond markets allow foreign issuers to issue bonds provided they fulfil local listing requirements. Such markets are generally known by rather quaint names such as the Yankee bond market in the US, the Bulldog market in the UK and the Samurai market in Japan. These markets have tended to be attractive to foreign issuers because of the status of issuing in the most established bond markets in the world. They are also attractive because the tenors available in these markets were often longer than available elsewhere. Traditionally, the Asian issuers issuing in the Yankee, Bulldog and Samurai markets have been sovereigns attempting to establish a certain name in these markets, and they usually paid a premium over their alternative borrowing costs for the privilege. The requirements for sovereign issuers in these markets are generally less onerous than for corporate issuers. The Hong Kong government, having neither the financial requirement, nor the reasons of national prestige to issue in overseas markets, has never done any such foreign bond issues. However, the government owned MTRC has been an issuer in both the Yankee and the Samurai markets. Local corporates have also become increasingly regular visitors to these markets in recent years.

The largest, most prestigious and most attractive of the foreign onshore markets is the Yankee bond market. It gives the issuers access

initial loan amount before 'general syndication' begins. The underwriting fee is paid on the amount of underwriting each bank takes.

Management and participation fees

These fees are paid to each bank as a percentage of the amount of the loan they actually fund. They represent the largest part of the arrangement fee. The percentage paid to each participant usually varies based upon the size of each bank's funding, with a larger percentage paid to banks making larger contributions to the loan. The fees increase the all-in yield on the loan assets for the lenders. As the more senior banks in the transaction receive higher fees their yields will be higher than those of the smaller lenders. For example, a bank taking a $10 million participation may receive a fee of 40bp on that amount whereas a bank taking a $5 million participation in the same deal may receive only 30bp on its commitment amount.

Given the varying percentages of fees paid to banks on their commitment amounts there is generally a pool of funds left from the fees at the end of the syndication. (Using the above example, if 50% of the amount sold in general syndication is made up of participations of $5 million, and 50% is sold to banks taking $10 million, there will be a pool of 50% of the amount syndicated multiplied by 10bp). This pool is generally divided among the arrangers of the deal.

Fees paid in Hong Kong for particular transactions in recent years have increased the all-in yield to loan participants anywhere from 8bp to 18bp above the interest margin. For example, on a $3.96 billion five-year term loan signed in March 1996 Cheung Kong paid a margin of 65bp, but an all-in yield of 75bp. On a $4 billion, five-year term loan signed in the same year local property company, Kerry Properties, paid a spread of 75bp which was augmented to 91.5bp all-in yield after fees were paid.[17]

Commitment fees

Commitment fees are the fees that the borrowers pay for the privilege of having a firm legal commitment from banks to fund the loan even though the borrower has not yet accessed the funds. By the late 1980s such fees were generally nominal (at ⅛% per annum or less) and often might be waived for several months for major borrowers. After the BIS capital adequacy requirements were announced in July 1988, banks had to begin considering that every $1 of committed loans had to have a certain level of capital held against it (see Section

17. Basisfield, Electronic Database.

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VIII below 'BIS Capital Adequacy Requirements'). By the early 1990s when loan pricing began to reflect the effects of the BIS regulations the commitment fees charged to borrowers had increased to reflect the opportunity cost of capital which had to be held against these commitments. From the early 1990s most commitment fees made public on loans in the Hong Kong market were ¼% or more. However, by 1996 in line with a general downturn in pricing, many transactions once again had commitment fees waived for short periods of time.

Trends in loan pricing

Loan pricing has seen some dramatic changes over the past decade or so. From the mid to late 1980s the prices on loans to top borrowers became increasingly 'thin', meaning that the spreads over LIBOR were reducing to low levels not seen previously. Despite, or perhaps because of, the losses experienced by many banks in the LDC debt crisis of the early 1980s, those banks active in syndications were ever more anxious to book loan business in parts of the world such as South East Asia. In order to actually win that business it seemed increasingly necessary to cut prices. To a large extent, in the South East Asian region, that price cutting was led by Japanese banks which had been less burned by the LDC losses in the early 1980s than the US houses. The Europeans were still a relatively small presence in the market.

In July 1988, the Bank of International Settlements (BIS) in Switzerland introduced guidelines with the agreement of its members (the central banks of the OECD countries) which would require commercial banks to keep capital of 8% against net risk assets. Not less than half of this amount must be core or Tier One capital. (Details of the agreement and weightings for different asset categories are outlined in Section VIII below.) Many countries' central banks set standards higher than the BIS requirements and nearly all serious financial centres around the world adopted the BIS minimum standards regardless of whether they were BIS members.

Hong Kong was one such financial centre, even though at the time of the guidelines Hong Kong was not a member of BIS. Hong Kong introduced capital adequacy guidelines in 1989.[18] The head offices of practically all commercial banks active in the syndicated loan market in Hong Kong were also constrained by the BIS guidelines. The effect of the BIS guidelines was to make loans more expensive. All banks had an opportunity cost in writing loans with very low margins. The opportunity cost of doing this low return business was other, potentially higher return, business.

18. Hong Kong was admitted as a member of the BIS in its own right along with the PRC and certain other Asian countries in late 1996.