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THE TEMPTATION TO INTERVENE: PROBLEMS CREATED BY GOVERNMENT INTERVENTION IN THE HONG KONG STOCK MARKET

Katherine Lynch

Introduction

In the last thirty years the Stock Exchange of Hong Kong (SEHK) has developed from a small local exchange into an international stock exchange currently ranking as the second largest exchange in Asia after Tokyo, in terms of market capitalisation, and overall the seventh largest stock market in the world. The stock market in Hong Kong did not truly function as a means of raising capital until the establishment of modern stock exchanges during the years 1969-72. In 1973 the Stock Exchange Control Ordinance was enacted which in effect limited the number of stock exchanges to four: the Hong Kong Stock Exchange (1891), Far East Stock Exchange (1969), Kam Ngan Stock Exchange (1971), and the Kowloon Stock Exchange (1973). A new era began for Hong Kong in 1986 with the unification of the four private exchanges and the establishment of the SEHK.

The economic turmoil in Asia over the past year has put the region’s financial markets under intense scrutiny, highlighting various problems, including the growing prominence of highly mobile and volatile forms of capital, extension of credit risky commercial loans by international banks, inadequate financial disclosure, lack of transparency, market manipulation, and cronyism. Hong Kong has not been immune from the impact of such economic turmoil. Following what was alleged to be a speculative move on the Hong Kong dollar (with its linked exchange rate mechanism with the US dollar) causing volatility in the financial markets in October 1997, the

* Associate Professor, Faculty of Law, University of Hong Kong. The author wishes to express her gratitude to Professors Yash Ghai and Betty Ho of the Faculty of Law, University of Hong Kong and an anonymous referee for their valuable comments on a draft of this article.


2 The SEHK is a limited liability company incorporated in 1980 under the Stock Exchanges Unification Ordinance, although trading on the new exchange did not begin until 2 April 1986. For discussion of the historical development of the stock exchanges in Hong Kong, see Tomasz Ujejski, 'Securities Regulation' in Raymond Wacks (ed), The Law in Hong Kong 1969-1989 (Hong Kong: Oxford University Press, 1989), ch 9.

3 Particularly in Indonesia, Thailand, Malaysia, and South Korea. For an insightful review of the factors leading to the Asian economic crisis — particularly the systemic changes in international capitalism and global capital flows — see Jeffrey A Winters, 'Asia and the Magic of the Marketplace' (December 1998) Current History 418.
government of the Hong Kong Special Administrative Region (HKSAR) undertook a review involving the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA), Hong Kong's de facto central bank. More recently, in August 1998, the Hong Kong stock market experienced further volatility when it is alleged that international hedge funds and investment banks (so called 'speculators') attacked the Hong Kong dollar and simultaneously reaped huge profits by short selling shares of Hang Seng listed shares and stock index futures.\(^4\) Subsequently, the HKMA intervened in the SEHK spending US$15b from its foreign reserves to purchase large quantities of listed shares in an apparent attempt to thwart the alleged currency speculators for what it called unfair attacks on the Hong Kong dollar.\(^5\) At the same time the government introduced a package of measures designed to 'tighten controls on stock and futures trading.'\(^7\) As a result, the government is now a major shareholder in many Hong Kong companies listed on the SEHK while at the same time, through entities such as the SFC and HKMA, it is also the regulator of Hong Kong's financial markets.

This article begins by reviewing the financial turmoil in Asia and the volatility in Hong Kong's financial markets over the last eighteen months which culminated in the government's unprecedented intervention in the stock market in August 1998 and the introduction of various measures to tighten up the securities and futures markets. It then analyses various problems raised by the government's intervention, including the unavoidable conflicts of interests created by the government being a major shareholder in several Hong Kong companies listed on the SEHK while at the same time acting as the primary regulator of the financial markets.\(^6\) It also considers the government's proposal to grant discretionary 'emergency' powers to the SAR Chief Executive to direct the exchanges and clearing houses in Hong Kong and argues that giving such discretionary directive power to the head of the government undermines the effectiveness of the regulatory authority of the SFC. Moreover, this hastily drafted measure is out of step with the international trend in stock

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\(^4\) More sensationallly referred to by the Financial Secretary, Sir Donald Tsang Yum-kuen, on 14 August as the 'huge crocodiles': see Jonathan Sprague, 'Fighting "Godzillas": Post-intervention Hong Kong Likely to Stick with the Free Market,' Asia Week, 23 October 1998, p 67.

\(^5\) 'Short selling' refers to the practice of borrowing stock and selling it on expectation that the price will fall before the stock has to be returned.

\(^6\) Government officials allege that multi-billion dollar hedge funds first take positions betting that the stock index will fall, then they mount attacks on the Hong Kong dollar. Since the currency is linked to the US dollar, it cannot fluctuate widely in value. Instead interest rates rise to make holding Hong Kong dollars more attractive, with the cost of borrowing raised. Stock prices fall, thus rewarding the speculators' original bets. The response of the hedge funds is that they are only responding to overvalued assets and currency.


\(^8\) This article does not comment on the government's measures to support Hong Kong's currency peg system in August 1998.
market regulation to vest clear and objectively stated powers in an independent but publicly accountable market regulator. Any further measures taken by the government must be part of a comprehensive and rational review of the financial and securities markets in Hong Kong, rather than the ad hoc crisis reaction style currently displayed. This is particularly important given the globalisation of financial markets, increased competition from other financial markets (particularly Singapore), and the need to continue to attract foreign investment to Hong Kong.

**Financial turmoil in the Asian region**

The financial turmoil sweeping through Asia this past year resulted in substantial downward pressure on stock markets around the region, an upsurge in interest rates, rising inflation, sharply depreciated currencies, and highly volatile currency exchange rate mechanisms. The regional economic turmoil started off in Thailand in the middle of 1997 when the Thai baht was substantially devalued and moved on through Malaysia, Indonesia, and the Philippines resulting in substantial depreciation of the Malaysian ringgit, Indonesian rupiah, and Philippine peso. By the end of 1997, further financial troubles in Japan and widespread corporate bankruptcies in South Korea rocked North Asia. The International Monetary Fund (the IMF) pledged a rescue programme amounting to US$3.9b to assist the Thai government, and further rescue programmes for South Korea and Indonesia amounting to US$23b and US$57b respectively. These events have had a compound effect on one another, resulting in a serious regional crisis with profound global implications.

**October 1997: volatility in Hong Kong's financial markets**

Hong Kong as an important international financial centre has not been immune from the financial turmoil sweeping through Asia as events over the

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9 The need for clear and objectively stated regulatory powers and for operational independence and public accountability of the market regulator is recognised in the Objectives and Principles of Securities Regulation adopted in September 1998 by the entire 150 member of the International Organisation of Securities Commissions (IOSCO) (of which Hong Kong is a member). The IOSCO principles are available at <http:/www.iosco.org>. See further discussion below at notes 73 and 110.

10 With Thailand and South Korea reforming their financial regulation with IMF assistance. For a critique of the IMF rescue packages for these Asian economies, see Richard Haass and Robert Litman, 'Globalisation and its Discontents' (1998) 77:3 Foreign Affairs 2. There is now extensive debate over the merits of Asian governments adopting short-term capital controls to avert a repetition of last year's financial contagion in the region. See discussion in Winters (note 3 above) and 'IMF Warms to Forex Controls,' South China Morning Post, 15 September 1998.

past year and in recent months have clearly indicated. In October 1997 the government claimed that speculators launched massive short selling of the Hong Kong dollar in the expectation that the linked exchange rate with the US dollar would be broken resulting in a competitive devaluation. Overnight interbank interest rates surged briefly to 280 per cent on 23 October under the automatic mechanism of the currency board system. During that week and the following week, the securities and futures markets in Hong Kong experienced the most serious volatility in history, recording a 1,438 points (13.7%) drop in the Hang Sang Index on 28 October with a 1,705 points (18.8%) rebound on the following day. There were several incidents of Hong Kong financial institutions encountering financial difficulties, including the November 1997 run on the International Bank of Asia, followed by the collapse in January 1998 of Peregrine Investment Holdings Ltd, one of the largest investment firms in Hong Kong. This was followed by the default of CA Pacific Securities Ltd in February and the further collapse of other local brokerage firms, including Forluxe Securities and Ming Fung Group, due to fraudulent misuse and misappropriation of clients’ funds.

Report on the Financial Market Review
In keeping with the crisis reaction pattern of regulatory reform, the Provisional Legislative Council pressured the government for a review of the currency defence mechanism and the operation of the securities and futures markets (its most wide-ranging review of Hong Kong’s financial markets since the post-

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12 Hong Kong slipped into a recession for the first time in thirteen years with the announcement on 29 August 1998 by the Financial Secretary Sir Donald Tsang that the economy had shrank by 5% in the second quarter (as measured by a 5% decline in the GDP or goods and services produced locally during the three months ending in June).

13 The Hong Kong government has not yet published any figures as to the extent of the alleged short selling of the Hong Kong dollar in October 1997.

14 The last major turmoil in the Hong Kong stock market occurred in 1987 when trading on Hong Kong's stock market was suspended for four days when the stock market crashed 43.2% as markets around the world responded negatively to Wall Street's 'Black Monday.' At that time, the Hong Kong government mounted a HK$4b rescue package to prevent the bankruptcy of the futures market.

15 Peregrine Investments Holdings Ltd was a publicly listed holding company which had eleven licensed entities providing a wide spectrum of financial services to the market. On 21 September 1998 shareholders of the Peregrine Group launched a lawsuit against four directors of Peregrine complaining of breach of fiduciary duty by the directors and negligent misrepresentation in statements made to the media in October 1997. See 'Shareholders Sue Peregrine Directors,' Hong Kong Standard, 21 September 1998.

Government intervention in the stock market

17. Involved in the review process were the SFC, HKMA, SEHK, Hong Kong Futures Exchange (HKFE), and the Hong Kong Securities Clearing Company (HKSCC). The review culminated in the publication on 23 April 1998 of the Report on the Financial Market Review (the Report),
18. criticised as irrelevant for failing to address the issue of the linked exchange rate mechanism, focusing instead on the old familiar problems in Hong Kong's securities and futures markets. The Report confirmed the stability of the present monetary system without directly addressing problems related to the defence of the currency board system and inadequate disclosure by companies listed on the SEHK. In the Report, the government affirmed (at least in print if not in practice) its commitment to maintaining and enhancing the status of Hong Kong as an international financial centre and stated as follows:

Market integrity is among the most important qualities vital to the maintenance of Hong Kong's status as a major international financial centre. Under the SFC Ordinance and other related legislation, the SFC is empowered to conduct investigations, either on its own initiative, or at the direction of the Financial Secretary, or upon public application, into suspected market malpractice including insider dealing and market manipulation. The SFC is committed to exercising its power whenever a case is demonstrated.

An important issue addressed in the Report was allegations of market manipulation, in particular, suggestions that insider dealing had occurred in connection with heavy short selling of shares of HSBC Holdings Ltd (the parent company of the Hong Kong Bank, one of the world's largest banks) in the SEHK on 29 and 30 October 1997 prior to the announcement by Moody's Investors Service on 30 October downgrading the outlook of Hong Kong's banks and placing the ranking of HSBC and Hang Seng Bank on review for possible downgrading. It was alleged that at that time certain parties had been aware Moody's was going to release a negative report and traders had sold or

17. The past reviews of the regulation of the securities market in Hong Kong have all been in response to financial crises: in 1973 following the collapse of the stock market, in 1987 following 'Black Monday' and the closure of the stock market, in October 1997 following the run on the Hong Kong dollar, and most recently in September 1998 following the government's intervention in the stock market. See discussion in Leslie S F Young and Raymond C F Chang, The Hong Kong Securities Industry (Hong Kong: SEHK Ltd, 1997), p 30.
19. Some of the Report's recommendations included: greater financial disclosure by listed companies, review of the share repurchase code, increased transparency and access to short selling, and increased sanctions for breaching the listing rules of the SEHK. See Report, pp vi–x.
shorted the shares based on that information.\textsuperscript{21} Although the Report concluded that the allegations of insider dealing appeared unsubstantiated,\textsuperscript{22} it recommended that the capability of the SFC and the exchanges to monitor trading and members' conduct be enhanced by strengthening their capability to obtain market information from intermediaries.\textsuperscript{23} In addition, the Report suggested that the SFC and the SEHK revise the financial disclosure rules of the SEHK Listing Rules to improve the transparency of financial exposure of listed companies to their investors and the market.\textsuperscript{24}

After a year-long investigation, the SFC concluded in a formal report published on 29 October 1998 that insider dealing had not occurred in relation to the sales of shares of HSBC Holdings on 29 and 30 October 1997.\textsuperscript{25} The SFC identified only three key brokerage firms who sold large quantities of HSBC shares on both days and accepted their explanations for such selling as 'logically and commercially justifiable.' Furthermore, the SFC accepted their denial of possessing any knowledge of Moody's announcement prior to the official release on 30 October 1997, no doubt influenced by Moody's assertion that great care had been taken to ensure that no information was disclosed to any external third party prior to its public announcement of the downgrading.\textsuperscript{26} In the Report the SFC noted that prior to Moody's announcement there had been considerable speculation on the future profitability of HSBC Holdings and the level of provisions it might make for bad debts in view of the regional financial crisis.

\textbf{August 1998: government intervention in the financial markets}

\textit{Unprecedented share purchase by the government}

In August 1998 the government claimed that speculative attacks were once again being mounted on the Hong Kong dollar and the fixed exchange rate to

\textsuperscript{21} HSBC Holdings shares rebounded to HK$1.88 on 29 October after dipping to a low of $1.55 on 28 October following a 4% drop in the Dow Jones Industrial Average overnight. The shares dived to $1.67 from $1.80 after Moody's announcement of its intention to downgrade the banking group on 30 October, before gradually recovering to $1.73.50. See Peter Chan, 'SFC Clears Trades in Probe on HSBC Deals,' South China Morning Post, 30 October 1998.

\textsuperscript{22} At the time of publishing the Report, the SFC established that almost all of the short selling of the HSBC shares was caused by the need for Hong Kong-based entities to reduce their large exposures to the Hong Kong market and not related to Moody's announcement. See Report (note 18 above), p 79.

\textsuperscript{23} Other recommendations include linking the Central Clearing and Settlement System of the HKSCC (which handles 99.5% of SEHK transactions) with the Real Time Gross Settlement System of the HKMA (which is the monetary settlement system among banks) in May 1998; reviewing the fidelity insurance and compensation schemes of SEHK to ensure the provision of cost-effective protection of investors and market practitioners; and establishing an Investor Resources Centre in 1998. See ibid, pp ix–x and 96–7.

\textsuperscript{24} The Report also recommended the introduction of measures such as application for court orders and mandatory remedies to strengthen the enforcement of compliance with SEHK Listing Rules.


\textsuperscript{26} Moody's stated that HSBC Holdings had been approached only thirty minutes prior to the official release of the downgrading announcement.
the US dollar. In an effort to take the pressure off the alleged speculation by
driving down the interest rate premium on Hong Kong dollar assets, the
government responded with a massive US$15.2b (HK$120b) share purchase
over the last two weeks in August. The volume of trade in the stock market
surged to HK$79b with the government estimated to have accounted for up to
90 per cent or more than HK$71b of the massive turnover. This intervention
by the government in the market, unprecedented in the history of the local
stock market, resulted in the government being the largest single shareholder
in HSBC Holdings, with an 8.9 per cent stake. The official policy expressed
by the government for its intervention was 'to restore order to [Hong Kong's]
financial markets ... to consolidate Hong Kong's ability to manage its monetary
affairs, so that we can counter manipulation of our markets ...'. Despite
criticism of the government's intrusion in the markets from economists and
many in the financial community, the Chief Executive stated in his Policy
Address on 7 October 1998 that the government's intervention in the market
and its introduction of measures aimed at supporting the financial markets were
not intended to 'interfere with market forces ... nor broaden the powers of the
Government.'

27 After an overnight meeting on 13 August 1998 between the Chief Executive, Financial Secretary
Donald Tsang, Chief Executive of the HKMA Joseph Yam, and Rafael Hui, Secretary for Financial
Services, a decision was made to intervene in the market and over the next ten days billions of dollars
from Hong Kong's reserves were poured into the stock market (referred to as 'Operation Purchase').
In total the government used up to US$8.8b (about HK$65.69b) of Hong Kong's US$96.2b foreign
reserve fund (or up to 9% of the total fund) in this share-buying spree. Subsequently, on 7 September
1998, the Financial Secretary appeared before the Financial Affairs Panel to explain and defend the
government's intervention in the markets. Minutes of this meeting are available at <http://www.

28 The turnover before the government began to intervene in the market on 14 August was a mere
Hong Kong $365b per day. Unfortunately, the high sovereign credit rating of Hong Kong was ultimately
downgraded as a result of the government intervention in the markets, as Standard and Poor
downgraded Hong Kong's credit rating from A+ to A on 2 September 1998. See Enoch Yiu, 'HKMA Speakers US$8 billion,' South China Morning Post, 22 September 1998.

29 Other stocks chosen for purchase by the government include property development and utility
companies such as Cheung Kong (Holdings) Ltd, Hong Kong and Shanghai Hotels, China Telecom,
New World Development, Henderson Land, Sung Hung Kai Properties Ltd, and Citic Pacific Ltd (see
the Appendix for a full list of stocks purchased). By choosing Hang Seng Index-linked stocks to
purchase, it could be argued that the government has implicitly endorsed the use of 'guanxi' or
connections in Hong Kong. See Dennis Ng, 'Intervention Puts Millions in Tycoon's Pockets,' Hong

30 See Chief Executive Tung Chee-hwa's second policy address, 'From Adversity to Opportunity' (7
19981007/cepa.htm>. Recent reports indicate that an investigation by the SFC of short selling
activities by the local broking industry in August 1998 has yet to uncover any incidences of short
selling that warrant prosecution. However, the Disciplinary Committee of the SEHK is investigating
at least one brokerage house allegedly heavily involved in short selling in August 1998. See Enchoh

31 See discussion of the criticism of the government's intervention below and notes 56 and 57. See also
comments made by some members of LegCo's Financial Affairs Panel on 7 September 1998 in
meeting with the Financial Secretary discussing the government's activities in the currency, stock,
and futures markets. See note 27 above.

32 See Policy Address (note 30 above), para 8.
Further measures to tighten up securities and futures markets

The massive intervention by the government in the stock market was only part of the measures taken by the government to support Hong Kong's financial markets. On 5 September 1998 the HKMA announced a package of seven measures to strengthen Hong Kong's currency board mechanism. Further government proposals followed two days later when the Financial Secretary unveiled before the Legislative Council (LegCo) a thirty-point package of measures designed to 'tighten' controls on stock and futures trading. One important measure was to restrict the short selling of Hong Kong shares in an attempt to prevent speculators from reaping profits on trades. It also reinforced more ruthlessly a rule that had previously been ignored — that anyone who sells shares short must have borrowed them first. In addition, the HKSCC tightened rules for settling stock trades, giving brokers two days after a trade is executed to deliver the shares. Other measures included increasing penalties for illegal short selling (increasing the maximum fine from $10,000 to $100,000 and jail term from six months to two years) and introducing legislation to make it a crime for short selling to be unreported or falsely reported to the regulatory authorities. More controversially, the government also proposed changing the law to grant greater powers to the Chief Executive, when public interest was under threat, to direct the SFC (the government's market watchdog), as well as the exchanges and the clearing houses. It is doubtful, however, whether

33 In announcing the regulations, the Financial Secretary stated that they should help 'maintain a level playing field' in terms of investors' access, information disclosure, and costs of holding short or long positions. See Bayani Cruz, 'Market in for Tighter Regulation,' Hong Kong Standard, 28 August 1998.

34 For an insightful critique of the government's measures to support the financial markets, see Betty Ho, 'Comments on "Measures to Tighten Up Securities and Futures Markets" Announced by the Financial Secretary of Hong Kong on 7 September 1998' (Faculty of Law, University of Hong Kong: Law Working Paper Series, Paper No 22, September 1998), p 2.

35 Although this does not necessarily prevent short selling of these shares offshore, as shares of HSBC Holdings Ltd are traded in London where they can be sold short. Similarly, shares of Hong Kong Telecom Ltd effectively trade on the NYSE through the company's American Depository Receipts. See Eric Guyot, 'Hong Kong Tightens Rules on Short Sales of Hong Kong Stock,' Asian Wall Street Journal, 3 September 1998, p 1.

36 Sending many banks and investment funds scrambling to buy shares to cover their positions. Other measures include: probing possible illegal short selling and other misconduct in the last two weeks of August; requiring stock brokers to report all short-selling trades to market regulators; introducing penalties for brokers flouting the T+2 rule (including suspension for rule-breaking members); and the establishment of a cross-market early warning system comprising the SEHK, HKFE, SFC, HKSCC, and HKMA to signals when futures activity exceeds a pre-set level on the cash market and set up response to trigger controls as needed. See critique of these measures by Professor Ho (note 34 above), pp 8–10.

37 Previously, the agency allowed more time to lapse and the rule, known as the 'T+2 settlement rule,' will hurt speculators who entered into contracts to sell short without even having those shares on hand. The rule is opposed by more than thirty international banks, brokers, and fund managers who argue that transactions across multiple time zones need to be exempted from the rule if major trading disruptions are to be avoided. See Stewart Oldfield, 'Confrontation Looms on Strict Enforcement of T+2 Deadline,' South China Morning Post, 16 September 1998, and Jake van der Kamp, 'Settlement Exempt Call on Shaky Ground,' South China Morning Post, 3 November 1998.

38 For a critique of the government's handling of the T+2 settlement 'saga' and the imposition of criminal sanctions, see Ho (note 34 above), pp 21–7.

39 At this point, it is not clear what circumstances will constitute the public being under threat to warrant the exercise of the Chief Executive's power. See discussion in Sprague (note 4 above), p 68.
there is any pressing need for the Chief Executive to have such widespread emergency powers to direct the exchanges and clearing houses, which are ostensibly private entities (see further discussion below).  

Creation of Exchange Fund Investment Ltd

For over two months from mid-August to the end of October 1998, the contents of the government's portfolio remained unknown. Under increasing public pressure and aware of the possible conflicts of interest of owning such large and influential stakes in leading Hong Kong companies, the government finally disclosed the amount of its shareholdings in 33 major Hong Kong companies listed on the SEHK on 26 October (see list of company shares purchased in the Appendix). The government's intervention resulted in it owning 7.5 per cent of the SEHK, reducing the free float (the number of shares that may be traded on any given day) on the Hang Seng Index by about 14 per cent, with the float on some company shares reduced by more than 25 per cent. The irony is that such reduced stock market liquidity may result in greater volatility — the exact opposite of what the government hoped to achieve.

At the same time as disclosing its massive shareholdings, the government announced its intention to incorporate a private limited company, the Exchange Fund Investment Ltd (EFIL), to act as the private fund manager of the government's US$15.2b equity portfolio. According to Financial Services Secretary Rafael Hui, the EFIL will manage the government's share portfolio according to guidelines issued by the HKMA and acting on the advice of the HKMA's Exchange Fund Advisory Committee. The clear intention is to attempt to detach the management of the government's huge equity portfolio from regulators and government administrators supervising Hong Kong's banks and financial institutions.

Subsequently, on 22 October 1998 the Financial Secretary appointed an eleven-member board (the Board) to manage the EFIL. The EFIL Board is composed of bureaucrats, legislators, and business persons chaired by former Chief Justice Yang Ti-liang (a member of the Executive Council). The

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40 Particularly since the current legislative framework already confers a power on the Chief Executive to give such directions to the SFC in writing as regards the performance of any of its functions as he considers appropriate — and the SFC shall, in performing its functions, comply with the Chief Executive's directions. See s 11, Securities and Futures Ordinance, and discussion by Ho (note 34 above), p 19.

41 See Enoch Yiu, 'Intervention Share Buys Made Public,' South China Morning Post, 27 October 1998.

42 See Chris Tinker, 'Players' Attacks on Intervention Smack of Self-interest,' South China Morning Post, 7 November 1998.

43 For example, if the government decides in the future to buy or sell particular shares, this could be viewed as a vote in favor of or against the locally listed company, which could in turn spark huge swings in the company's listed share price.


appointment of Mr Yang, who has no direct experience in business or fund management, is a weak attempt by the government to provide a degree of independence for the EFIL Board. The Board includes three HKMA officials (Deputy Chief Executive Norman Chan Tak-lam and Executive Directors Marian Li Chan Siem-mun and Amy Yip Yok-tak), three legislators (Chan Kam-lam of the Democratic Alliance for the Betterment of Hong Kong, Edward Ho Sing-tin of the Liberal Party, and independent member Eric Li Ka-cheung), one financial professional (investment actuary Stuart Leckie), and one academic (Professor Tsang Shu-ki of Hong Kong Baptist University). The final two members of the Board are Financial Services Deputy Secretary Rebecca Lai Ko Wing-yee and a retired solicitor, Michael Thornhill. In announcing the members of the EFIL Board the government stated that, although the EFIL will not conduct active trading of the equity portfolio, it is responsible for ‘identifying value-added opportunities for the eventual disposal of the shares with minimum disruption to the market.’ In early January 1999 the SFC granted an investment adviser’s licence to the EFIL which enables the company to actively manage the government’s portfolio. However, the government has stated that it intends to hold on to the shares as a long-term investment and is in no hurry to dispose of them. While the Board members will advise the government and manage the EFIL’s operations, it is understood that the Financial Secretary retains the right to veto Board decisions.

Analysis of the government’s intervention in Hong Kong’s financial markets

In assessing the government’s intervention in the financial markets, it is ironic to note that, while the government previously called for greater transparency and freer market mechanisms in its April 1998 Report, its present actions appear to be moving one of Asia’s most laissez-faire markets in the opposite direction. The intervention of the government in the stock market to fend off alleged speculative attacks on its currency and short selling activities, as well as the granting of discretionary powers to the Chief Executive, restrict the transparency and certainty of Hong Kong’s financial markets. As the economic crisis deepens in Asia, however, other governments around the region have

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46 It is highly questionable whether the appointment of the former Chief Justice, who lacks any real experience in fund management, can provide any guarantee of independence on the Board, particularly in view of the large number of HKMA officials on the Board.
48 See comments of Financial Services Secretary Rafael Hui reported in Hoi Leung (note 44 above).
49 See Peter Chan, ‘SFC Gives Go-ahead for EFIL to Trade,’ South China Morning Post, 6 January 1999.
50 See Bashford (note 45 above).
51 Recall the proposals contained in the government’s April 1998 Report. For further discussion of this point, see the editorial ‘Temptation to Meddle,’ Far Eastern Economic Review, 27 August 1998, p 70.
shown a similar willingness to actively intervene and manage their domestic economies.\textsuperscript{52}

**Criticism of the government's intervention in the financial markets**

As the government propped up share prices, targeted the profits of market players, and established large holdings in companies listed on the SEHK, Hong Kong's reputation as the global icon of laissez-faire capitalism was called into question.\textsuperscript{53} It is arguable, of course, whether Hong Kong has ever really had a 'free' economy given the amount of government control over the property, housing, transportation, power, and (until recently) telecommunications sectors of the economy and the currency peg system.\textsuperscript{54} Although the Financial Secretary, Sir Donald Tsang, and the Chief Executive of the HKMA, Joseph Yam, argue that the intervention was essential to maintaining the stability of Hong Kong's financial markets, the government has been criticised for its interventionist acts.\textsuperscript{55} Some economists such as Milton Friedman argue that such intervention has substantially distorted the stock market, is totally unnecessary and counter-productive for the defence of Hong Kong's currency, and jeopardises Hong Kong's status as one of the world's 'freest economies.'\textsuperscript{56}

To them it appears contrary to the laissez-faire free market policies that are the foundation of Hong Kong's economic success and standing as an international and regional financial centre.\textsuperscript{57}

\textsuperscript{52} Consider, for example, the recent decision by Malaysia's Prime Minister Mahathir to impose severe capital controls and halt foreign dealing in Malaysia's currency and the Japanese government's $500b rescue package for its ailing financial institutions. Even the US has not been immune from such corporate bailouts. In September 1998 Long Term Capital Management was saved from collapse by a US$3.6b rescue package cobbled together by the Federal Reserve Bank of New York and a consortium of fourteen US and foreign lenders. The difference with this corporate rescue, however, was that it did not involve use of any government funds. For a critique of state intervention in the Asian economies, see Editorials, 'Market Intervention Fashionable' and 'The Case for Global Finance,' The Economist, 5 and 12 September 1998, pp 17 and 71 respectively and Ricardo Salado, A New Course, AsiaWeek, 23 October 1998, p 58.


\textsuperscript{54} See discussion of this issue in Yash Ohai, Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law (Hong Kong: Hong Kong University Press, 2nd ed 1999), pp 27-9.

\textsuperscript{55} See discussion of criticism of government's interventionist activities in Sprague (note 4 above), p 68.


\textsuperscript{57} Consider the criticism by Nobel laureate economist Milton Friedman and Alan Greenspan, US Federal Reserve Chairman (arguing that the intervention was done to 'jack up' the stock market in Hong Kong and would ultimately fail and undermine the credibility of the HKMA). See review of the criticism in David Ibison, 'Battle to Sustain Economic Eminence,' South China Morning Post, 1 February 1999. In this regard, it is open to debate as to whether the government's intervention is in conformity with Art 109 of the Basic Law which requires the government to provide an 'appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.'
However, others such as noted economist Paul Krugman support the intervention, arguing that the HKMA had no alternative but to intervene if international hedge funds were deliberately manipulating Hong Kong’s financial markets.\footnote{See Barry Porter, ‘Krugman in Support of Intervention,’ South China Morning Post, 28 August 1998 and discussion in Sprague (note 4 above), p 68. See also Paul Krugman, ‘I Know what the Hedgies Did Last Summer,’ Fortune, 21 December 1998 (available at <http://web.mit.edu/Krugman/www>).} Others dismiss the suggestion of the destruction of the free market principle in Hong Kong as ‘arrant nonsense,’ arguing that in reality all the HKMA did was change the rules of the game — replacing short sellers of the market with genuine buyers of the stock.\footnote{See Tinker (note 42 above).} However, at a conference in Hong Kong in November 1998, Nobel laureate economist Merton Miller joined currency peg architect John Greenwood in criticising the government’s intervention in the financial markets. Both Greenwood and Miller urged the government to immediately liquidate and dispose of its equity portfolio (by auction if necessary), even if it meant the government had to suffer a loss as a result.\footnote{See Karen Cooper, ‘Intervention a Blunder’ (13 November 1998), Helen Johnston, ‘Greenwood Urges Sale of Holdings’ (8 November 1998), and ‘Miller Wipes Away SAR’s $30b smile’ (15 November 1998), all from South China Morning Post.}

**Illegal manipulation of the stock market**

More controversial is the assertion that the government’s intervention in the market amounts to illegal manipulation of the stock market and the creation of a false market contrary to the provisions of s 135 of the Securities Ordinance.\footnote{Section 135, Securities Ordinance provides that no person shall intentionally create or cause to be created, or do anything with the intention of creating: (a) a false or misleading appearance of active trading in any securities on the SEHK; or (b) a false market in respect of any securities on the SEHK. For the purposes of s 135(1)(b), a false market is created when the market price of those securities is raised or depressed or pegged or stabilised by means of: (a) sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for those securities that is not justified either by the assets or profits of the company; (b) any act which has the effect of preventing or inhibiting the free negotiation of market prices for the purchase or sale of the securities; or (c) the employment of any fictitious transaction or device or any other form of deception or contrivance.} It is reported that in August 1998, when the government first intervened in the market, it initially bought futures positions ahead of its own subsequent purchases of listed shares in the equity markets, bidding up the share prices. As a result, the Hang Seng Index rose upwards approximately 400 points, providing the government with ‘profits’ of approximately HK$2b in the futures market. This activity on the part of the government could arguably constitute market manipulation (the creation of a false or misleading appearance of active trading) under s 135, which provides that a ‘false market’ is created when the market price of shares is raised by means of sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for those shares that is not justified either by the assets or profits of the company.
Not surprisingly, the government vehemently rejects this suggestion and claims it has immunity from application of the Securities Ordinance by virtue of s 66 of the Interpretation and General Clauses Ordinance,\(^\text{62}\) which provides that 'no ordinance shall in any manner whatsoever affect the right of or be binding on the State unless it is therein expressly provided or unless it appears by necessary implication that the State is bound thereby.' Since there is no expressed provision to bind the State in the relevant securities ordinances, the government argued that its operations were outside the jurisdiction of the SFC. However, s 66 expressly provides that the government is not immune from application of ordinances, such as the Securities Ordinance, if it appears by 'necessary implication' that the government is bound by the terms of the ordinance. The government has deliberately intervened in Hong Kong’s securities and futures market with its initial purchase of futures positions and subsequent purchase of massive equity shareholdings in a large number of Hong Kong listed companies. As such it is now a major player in Hong Kong’s securities and futures markets and should be subject to the same set of regulations as other market players. If the relevant securities ordinances do not apply to the government as an important shareholder in many listed companies in Hong Kong, then how can these ordinances effectively regulate Hong Kong’s securities and futures markets and their participants? The simple answer is that they cannot. The effective operation of the securities ordinances will be severely curtailed, if not impossible, if the securities ordinances do not apply to the government as a major participant in Hong Kong’s financial markets. It is imperative that the prohibition in the Securities Ordinance against illegal manipulation of the stock market should apply with equal force to the government.

Certainly the intervention is contrary to the government’s previous policy of positive non-intervention — a policy which supported businesses in Hong Kong but limited interference in the financial markets.\(^\text{63}\) ‘The government’s decision to intervene in the stock market, however, is a clear signal that the government desires a greater role in managing Hong Kong’s economy than it

\(^{\text{62}}\) The government also claimed that it was exempt from other legislation regulating the securities and futures markets in Hong Kong, such as the Securities and Futures Commission Ordinance and the Securities (Disclosure of Interests) Ordinance (see notes 66, 67, and 84 below). See Enoch Yiu, ‘Yam Rejects Accusations of Creating False Market through Manipulation,’ South China Morning Post, 20 August 1998 and minutes of meeting between the Financial Secretary and LegCo’s Financial Affairs Panel on 7 September 1998 (note 27 above), para 30.

\(^{\text{63}}\) In its April 1998 Report (note 18 above) the government stated at p 4: ‘We have non-interventionist policies whereby private enterprises are left to make their own business decisions, for which they are entirely accountable, and where the government facilitates, not directs, the development of the economic sector.’
has previously exercised. Professor Tsang Shu-ki suggests, however, that Hong Kong’s previous policy of ‘positive non-intervention’ prior to the handover was really ‘a policy of no commitment and no planning’ that created a bubble economy dominated by property and less able to weather economic storms than the more diversified economies of Singapore and Taiwan.

Disclosure of government shareholdings
An important issue that arose immediately upon the government’s purchase of Hong Kong company shares in August is whether the government, as a major corporate shareholder in Hong Kong listed companies, is exempt from the laws requiring public disclosure of shareholdings. The government originally argued that it was not bound by such requirements, and vigorously resisted calls to disclose its holdings in locally listed companies. The SFC appeared to accept the government’s contention, although the former Chairman of the SFC, Anthony Neoh, repeatedly called upon the government to disclose the government’s stocks as soon as possible. For over two months, from mid-August to the end of October, the contents of the government’s portfolio remained unknown. Moreover, it was subsequently revealed that the government purchased more than 10 per cent of three listed companies — Swire Pacific, New World Development, and Cheung Kong — but failed to disclose its shareholdings in accordance with the provisions of the Securities (Disclosure

64 Of course, the government does not practise the policy of non-intervention in all areas as it has extensively intervened in the property market in Hong Kong — controlling the land supply and selling sites to property development companies. Recently, the government resumed land sales after halting them in July 1998 for nine months after property prices in Hong Kong plunged. During the October 1987 stock market crisis the government simply took no action on the basis of its philosophy of non-intervention and that it lacked any statutory authority to intervene into a private company such as the SEHK. See discussion in Berry F C Hsu, Laws of Banking and Finance in the Hong Kong SAR (Hong Kong: Open University of Hong Kong Press, 1998), p 240.

65 See views expressed by Professor Tsang in Sprague (note 4 above), p 69.

66 For example, the provisions of the Securities and Futures Commission Ordinance, Securities (Disclosure of Interests) Ordinance, the Listing Rules of the SEHK, and the Code on Takeovers and Mergers require disclose of acquisition of shareholdings equal to or exceeding 10% of the company’s share capital. See note 20 above.

67 As discussed above, the government argued that it was not bound by the securities legislation and the Code on Takeovers and Mergers by virtue of s 66 of the Interpretation and General Clauses Ordinance. However, in order to prevent defeating the plain intention of the legislature, such legislation should apply to the government as a major shareholder of several listed companies. See Robert H P Fung v First Pacific Bank Ltd [1989] 2 HKLR 614. See also Cathy Holcombe, ‘HKMA “Not Bound” by Ordinance as Analysts Claim Price-sensitive Information Withheld’ and ‘Government Shuns Rules on Disclosure,’ South China Morning Post, 3 September 1998. See Ho (note 34 above), p 36 for further discussion.

68 The government initially refused to reveal whether it would disclose details of its shareholdings when the company was established, although it had to disclose its shareholdings in HSBC Holdings Ltd in order to comply with the disclosure provisions of the UK law which requires disclosure for acquisitions of shareholdings above a 3% level. See Editorial, South China Morning Post, 23 October 1998, Enoch Yiu, ‘Reveal Stakes, Urges Neoh,’ South China Morning Post, 30 September 1998, and Bayani Cruz, ‘October Launch for Shares Minder,’ Hong Kong Standard, 1 October 1998.

69 See Yiu (note 68 above) and Cathy Holcombe, ‘SFC Scrutinises Non-disclosure,’ South China Morning Post, 4 September 1998.
of Interests) Ordinance and the Code on Takeovers and Mergers. As discussed above, it is difficult to see how the government can credibly argue that it is exempt from the disclosure provisions of these ordinances and subsidiary legislation due to the 'necessary implication' clause in s 66 of the Interpretation and General Clauses Ordinance.

Such failure by the government to disclose its substantial shareholdings is disappointing and completely inconsistent with the government’s previous calls for and alleged commitment to greater market transparency. Recall that in its April 1998 Report, the government stated that ‘efficient and appropriate disclosure of information and the accessibility of such information to investors are crucial elements of market transparency.’ Moreover, it stressed the ‘importance of enhancing market transparency to enable investors to make their decisions based on equal and adequate knowledge about the fundamentals and prospects of the companies.’ It is imperative for the government to comply, and be seen to comply, with all the relevant market regulations concerning both disclosure and dealing as required of other investors in Hong Kong. Otherwise its large purchase of the public float may be perceived by market investors as conferring special status on the government as a shareholder as compared to other private investors in the market. Furthermore, the government’s failure to disclose its holdings in many major Hong Kong companies created an ill-informed and uncertain market.

Conflicts of interest created by the government intervention

Unfortunately, the government’s actions have created unavoidable conflicts of interest since it is now a major shareholder in many Hong Kong companies listed on the SEHK, while at the same time being the primary regulator of the financial markets. Government policies and regulations often affect the price of shares of companies listed on the SEHK and yet the government is now a major shareholder of many large listed Hong Kong companies. Despite the

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70 The new Chairman of the SFC, Andrew Sheng, recently confirmed that the SFC would not take action against the government for any of its trading activities during the August intervention, arguing that the HKSAR government was exempt from the provisions of the Securities (Disclosure of Interests) Ordinance in accordance with s 66 of the Interpretation and General Clauses Ordinance.

71 See Report (note 18 above), pp ix and 55.

72 Moreover, the government’s lack of disclosure and transparency are similar to some of the problems evident in the financial crisis in Asia, including inadequate financial disclosure and lack of transparency.

73 See comments of the former SFC Chairman, Anthony Neoh, in a speech entitled ‘Where Do We Go From Here?’ given on 29 September 1998 to the Hong Kong Institute of Directors, stressing the need for markets that are ‘fair, efficient, liquid and transparent.’ Available at <http://www.hkifc.org.hk/ eng/press/98/sep98.htm>.

74 The World Trade Organisation has criticised the government’s intervention in the stock market on this basis, noting that the intervention may work to the advantage of some market participants to the detriment of others. See IMF, World Economic Outlook: 1998 (Washington: IMF, October 1998), pp 7, 100-6 and Sheel Kohli, ‘WTO Blasts Government Share Buys,’ South China Morning Post, 9 December 1998.
government’s efforts to downplay the conflict, the fact remains that it is both
the owner of Hong Kong shares and the regulator of such shares. The
how can the
government be seen as a fair regulator of companies when it is a major
shareholder in many such companies? The most glaring example of
the conflict of interest arises from its 8.9 per cent stake in HSBC Holdings Ltd
which is directly supervised by a government entity, the HKMA. Another
example is the large shareholdings the government has in several major Hong
Kong property conglomerates. The government has become the second largest
shareholder of three property developers, holding 12.28 per cent of Swire
Pacific, 11.91 per cent of New World Development, and 10.34 per cent of
Cheung Kong (Holdings) Ltd. At the same time, however, the government is
the sole supplier of fresh property for real estate development that it releases to
these property development companies by public auction.

A further conflict of interest arises due to the government acting as manager
of the public’s investments in the stock market through the EFIL. As such, it
acts in a fiduciary position in relation to the public in managing the substantial
equity portfolio. The government owes a duty to the Hong Kong public to
protect the value of its equity portfolio and maximise profit on this investment.
At the same time, however, the government has a responsibility to regulate
Hong Kong’s financial markets to ensure Hong Kong’s continuing viability as
an international financial centre. As a result, the government has placed
itself in a direct conflict of interest — its responsibilities to the public as
managers of the government’s massive equity portfolio conflict with its
responsibilities to adequately regulate and monitor Hong Kong’s financial
markets.

Related to these unavoidable conflicts of interests is the potential for
officials managing the government’s investments to deal on confidential price-
sensitive information emanating from other government departments unless
effective preventive measures are taken to ensure that such information is not
passed between the respective government authorities (eg the establishment of
‘Chinese walls’). Clearly the intention behind forming the EFIL was to

75 They are, in effect, both the player and the referee in the stock market game. See discussion in Mark
Magnier, ‘Asian Governments Set Down Rocky Road with Market Intervention,’ Hong Kong
76 For example, if the government maintains a large shareholding in Hong Kong Telecom, it will have
difficulty being viewed as a fair and disinterested regulator of the telecommunications industry in
Hong Kong. See Chris Chapel, ‘Government Intervention Worries Investors,’ South China Morning
77 See Ewan McKendrick, Commercial Aspects of Trusts and Fiduciary Obligations (Oxford: Clarendon
78 Art 109, Basic Law endorses this: the government shall provide an ‘appropriate economic and legal
environment for the maintenance of the status of Hong Kong as an international financial
centre.’
79 Referring to private internal rules established by organisations in order to manage conflicts of
interests and prevent leaks of confidential price-sensitive information between departments within
the organisation.
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separate government administration from management of the government's large equity portfolio. However, the formation of this company does not of itself solve or prevent conflicts from arising, nor does it prevent the release of confidential price-sensitive information by government officials to managers of the EFIL. Unfortunately, the present legislative provisions governing insider dealing do not cover this problem since the definition of what constitutes confidential price-sensitive information (or 'relevant information') is restricted to specific information about a company. It does not extend to general misuse of an informational advantage, ie confidential price-sensitive information relating to the economy or certain sectors of it.  

The problem is exacerbated by the particular style of government in Hong Kong in which a large number of 'consultative bodies' drawn mainly from business interests are directly involved in the government on a daily basis. As a result, there is a large number of financial 'elites' having access to valuable information — although not necessarily specific to any company — but which may be exploited for financial advantage or gain. Unfortunately, the current provisions of the Securities (Insider Dealing) Ordinance do not proscribe such misuse of general informational advantage. In view of the conflicts of interest created by its intervention in the stock market, however, it is incumbent upon the government to consider revising these legislative provisions to maintain a level playing field for investors in terms of equal access to information.

Problems with the Exchange Fund Investment Ltd

The government's main purpose in establishing the EFIL is to attempt to draw a dividing line between the government's administration and management of its equity portfolio to avoid claims of conflict of interest. The EFIL will be subject to regulatory scrutiny by the SFC and must adhere to provisions of Hong

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80 See definition of 'relevant information' in relation to a corporation in s 8, Securities (Insider Dealing) Ordinance: 'specific information about that corporation which is not generally known to those persons who are accustomed or would be likely to deal in the listed securities of the corporation but which if it were known to them to be likely materially to affect the price of those securities.' See further discussion of this point by Ho (note 34 above), pp 37-9.


82 In this regard, it is interesting to note the comments of Ronnie Chan Chi-chung, chairman of Hang Lung Development, and more recently those of Li Ka-shing, chairman of Cheung Kong (Holdings) Ltd, complaining about the business community's diminishing influence in government due to the rising power of political groups in Hong Kong. See David Saunders, 'Hang Lung Head Fears Political Groups will Eclipse Economy-driven Leadership,' South China Morning Post, 12 December 1998.

83 For example, the European Economic Community Directive Coordinating Regulations on Insider Dealing of 13 November 1989 (89/592/EE) provides that 'inside information' covers information which is likely to influence the market as a whole, eg information relating to the economy such as interest rates, public borrowing levels, and employment figures, as well as political events. See further discussion of this point by Ho (note 34 above), p 38.
Kong law concerning dealing and disclosure.\textsuperscript{84} However, the formation of the EFIL to manage the government’s stock portfolio and the appointment of its Board members create problems. First, despite government claims that the EFIL Board is independent, the Board lacks true independence since one-third of the Board members are government officials: three HKMA officials and the Deputy Secretary for Financial Services.\textsuperscript{85} The EFIL will manage the government’s share portfolio according to guidelines issued by the HKMA and acting on the advice of the HKMA’s Exchange Fund Advisory Committee.\textsuperscript{86} Moreover, an executive director of the HKMA, Marian Li Chan Sien-mun, has been appointed Chief Executive of the EFIL and she will lead a team of fifteen professional investment staff seconded from the HKMA to run the daily operations of the EFIL. Given the heavy HKMA involvement in the operations and decision-making process of the EFIL, it is unlikely that it will make truly independent investment decisions.\textsuperscript{87} In any event, investment decisions the EFIL Board makes are potentially subject to veto by the Financial Secretary.

Second, it would have been preferable for the government to appoint more independent financial advisors to manage its large equity portfolio. As it now stands, the only member of the Board having any direct fund management experience in the private sector is Stuart Leckie.\textsuperscript{88} Two other members of the EFIL Board have fund management experience, Amy Yip Yok-tak and Marian Li Chan Sien-mun, but their independence is questionable since they are both employees of the HKMA.\textsuperscript{89} Given the need for professional fund management of the government’s large portfolio, the appointment of more independent and experienced fund managers would enhance the credibility of the EFIL Board.

Third, at this point it is unclear what the precise mandate of the EFIL and its Board is and how it is to operate. The biggest concern for the investing public is when and how the government’s huge shareholdings will be sold back into

\textsuperscript{84} For example, the Securities Ordinance, the Securities and Futures Ordinance, Securities (Disclosure of Interests) Ordinance, and the Code for Persons Registered with the SFC (see discussion in notes 62, 66, and 67 above). The Board of the EFIL confirmed that it will not buy or sell shares in Hong Kong until it is fully registered with the SFC as an investment advisor and securities dealer (which was approved by the SFC in early January). See Enoch Yiu, ‘EFI Stays in Sidelines until Regulator Clears Trading License,’ South China Morning Post, 16 November 1998, and Chan (note 49 above).

\textsuperscript{85} The legislator representing the financial services constituency, Fung Chi-kin, has questioned the independence of the Board given the involvement of so many government officials. Democratic Party deputy spokesman of financial affairs, Albert Ho Chun-yin, has also suggested that the EFIL will not make its own decisions but rather will simply follow the decisions made by the Financial Secretary. See Enoch Yiu, ‘Yam Defends Autonomy of SAR Share Custodian,’ South China Morning Post, 23 October 1998.

\textsuperscript{86} See Yiu and Ho Leung (note 44 above).

\textsuperscript{87} Furthermore, as Professor Ho has commented, the legitimacy of the EFIL Board is questionable given that potential dissonant voices on the Board have effectively been silenced because of the appointment of three HKMA officials and the Deputy Secretary for Financial Affairs.

\textsuperscript{88} See discussion of this point in Jake van der Kamp, ‘Our Money Managers Leave us Short-changed,’ South China Morning Post, 24 October 1998.

\textsuperscript{89} While there is no question of the competence and professionalism of these two members of the Board, it is difficult to see how they can act independently on the Board given their employment links to the HKMA.
the market, with the potential for further market volatility. Will the government sell all it stocks over a six-month period, or will it hold them forever as part of the Exchange Fund reserves? Alternatively, will it sell the shares back to the companies? The government has stated its intention to hold its equity portfolio for long-term investment and confirmed that, although the EFIL will not conduct active trading of the equity portfolio, it is responsible for 'identifying value-added opportunities for the eventual disposal of the shares with minimum disruption to the market.' However, the government is coming under increasing pressure to sell its shares as a number of eminent economists have urged LegCo to immediately dispose of all shares held in its equity portfolio to minimise volatility in the market.

There has been widespread speculation that the government may approach listed companies to buy back all or part of the shares it acquired during the August buying spree to avoid selling directly into the market and any excessive volatility resulting therefrom. The EFIL will form an advisory panel consisting of three international investment banks (ING Barings Asia, Jardine Fleming Securities, and Goldman Sachs) which will propose the terms for disposal of the government's large investment portfolio (either by share placements, public auction, unitisation, or structured convertible bond issues) and then execute the disposal. However, despite repeated government assurances that its equity portfolio will be held for long-term investment, many in the financial community are pressuring the government to end the uncertainty by publicly stating its investment policy and strategy. In early March the government announced that it would reduce local equities held in the Exchange Fund from 17 per cent to 5 per cent of the Fund, indicating that approximately $100b

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90 There have been rumors floating around of institutional investors wanting to purchase the government's large shareholdings in certain companies. Consider, for example, the recent rumors abounding in London and Hong Kong in the middle of October that the government's 8.9% stake in HSBC Holdings Ltd was facing a bid from Deutsche Bank. See Bloomberg, 'HSBC Share Soars on Buy-in Rumors,' Hong Kong Standard, 15 October 1998.

91 See comments of Financial Services Secretary Rafael Hui, reported in Hoi Leung (note 44 above). Yang Ti-liang, the Chairman of the Board of EFIL, has stated that the stock will be sold slowly and that the EFIL will not aim to make a profit for the portfolio. It will only buy and sell to maintain the asset value of the shareholding. It will not actively trade in the market.' See Staff Reporters, 'Government Urged Not to Sit on Boards,' South China Morning Post, 27 October 1998 and Enoch Yiu, 'EFI is Urged to Define Policy on $150b Portfolio,' South China Morning Post, 24 October 1998.

92 See note 60 above.

93 See Mukul Munish and Juanito Concepcion, 'Listed Firms May Buy Back Shares,' Hong Kong Standard, 28 October 1998.

94 It is understood that ten international investment banks met with the EFIL Board 4-7 February 1999 and submitted tender proposals, with detailed suggestions for disposal of the shares, their fees and charges, and how they would help EFIL execute the disposal. See Stewart Oldfield, 'Investment Banks Offer EFI Ways to Offload Portfolio,' South China Morning Post, 12 November 1998, Enoch Yiu, 'Banks Tussle for Seats on EFI Advisory Panel,' South China Morning Post, 4 February 1999, Enoch Yiu and Stewart Oldfield, 'More Banks Considered in Share Disposal,' South China Morning Post, 24 March 1999, and Hoi Leung, 'Three Banks Selected as Advisers on EFI Equity,' Hong Kong Standard, 30 April 1999.

95 See Johnstone (note 60 above).
worth of shares would be sold (although the timetable and ways of disposal of the shares have yet to be determined). 96

There is a pressing need for the government to end the uncertainty and expressly and publicly clarify EFIL’s investment guidelines, policy, and strategy in order to dispel market concerns about the equity portfolio and its eventual disposal. 97 This is particularly true given the fact that the government has recently merged its HK$12b equity portfolio previously held by the Land Fund with the US$15.2b portfolio of Hong Kong shares to be placed under the control of the EFIL. The result is that the EFIL, created to manage the shares purchased during the government’s market intervention in August, is now becoming the government’s permanent equity portfolio manager. 98

Furthermore, it is unclear how transparent EFIL’s operations will be and the degree to which its investment strategy and decisions will be publicly disclosed. The massive government intervention, which has complicated the risk profile of the Hong Kong stock market, requires full and complete disclosure by the EFIL of its shareholdings and investment decisions and strategy. Failure to make such disclosure will have a detrimental effect on Hong Kong’s financial markets. In its April 1998 Report, the government itself noted the need for disclosure of information accurately and efficiently to all market parties so that the financial risks associated with any investment can be detected and managed in time. 99 Presumably the nature of the EFIL’s business will necessarily restrict the level of disclosure of market-sensitive information since it will not want to jeopardise its own investment strategy. 100 While it may release information about its operations after a time delay, this will not be of much use to public investors. However, it is imperative that, after each sale from its equity portfolio, the EFIL make full public disclosure in order to maintain some level of transparency and accountability. 101 A related question is who are the

97 More importantly, as Professor Ho has commented the government must be consistent in its statements about its investment intentions – since August such statements appear to have changed from one week to the next. See note 34 above.
98 See David Ibson and Enoch Yiu, ‘Funds Fused to Fortify Dollar against Attack,’ South China Morning Post, 18 November 1998 and Chan (note 49 above). In this regard the EFIL will be similar to the Singapore government’s investment company, Temasek Holdings, which has assets of $777b and controls one third of the Singapore’s stock market with substantial (if not majority) shareholdings in many large Singapore companies (including Singapore Telecom and Singapore Airlines).
100 See discussion of this point in Bayani Cruz, ‘Officials Make Up Majority in Fund Board,’ South China Morning Post, 24 October 1998.
101 The EFIL may operate similar to the US Federal Open Market Committee in which information about its meetings is disclosed to the public after a sufficient time lag. The government should avoid following the secretive practices of the Singapore government in the operations of Temasek Holdings, its official investment arm. Temasek refuses to release any financial statements or details about its equity portfolio or operations and Temasek officials refuse to give public interviews. See Cruz (note 100 above) and Editorial, ‘Temasek on Shopping Spree,’ South China Morning Post, 20 November 1998.
ultimate beneficiaries of the EFIL? One suggestion is that the fund's holdings will form the initial subscription to a Hong Kong Provident Fund but this would have an impact upon the investment strategy of the fund. 102 Both of these issues require immediate clarification and public disclosure from the government.

Fourth, the issue of whether the government will seek positions on boards of the Hong Kong companies in which it bought shares is troubling. The government's representatives on these companies' boards may have knowledge of relevant government policy and yet, at the same time, they will be involved in formulating the companies' actions, decisions, and strategies. The government has publicly announced that it will not seek board positions and that it will remain a totally passive shareholder. 103 However, in the three companies in which the government holds more than 10 per cent shareholdings (Swire Pacific, New World Development, and Cheung Kong), it may appoint a representative to the companies' boards. 104 Under the rules of the SEHK, any investor holding more than 10 per cent of the issued stock of a company has the right to a seat on the company's board. However, Swire Pacific and New World Development have expressed serious reservations about government representatives assuming seats on their boards due to potential conflicts of interests. 105

The final troubling issue is that the creation of the EFIL, and the management of the government's huge equity portfolio primarily by HKMA officials, is a challenge to the development of constitutionalism in Hong Kong and the need for fair, transparent, and accountable government institutions. 106 The creation of this new financial institution in Hong Kong undermines both the operation of Hong Kong's financial markets and the fair and open system of financial governance in Hong Kong. 107 Moreover, it is the exact opposite of the Chief

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102 See discussion of this point by Jake van der Kamp, 'Declared Shareholding Fails to Dispel All Doubts,' South China Morning Post, 28 October 1998.

103 However the government has reserved the right to send representatives to the boards of listed companies to 'safeguard its shareholdings as they were bought with tax-payers' money.' See David Saunders, 'Tsang Confirms No Board Seats following $118b Investment,' South China Morning Post, 31 October 1998 and Stephen Seawright and Mukul Minish, 'Government Won't Seek Seats on Firms' Boards, says Tsang,' Hong Kong Standard, 31 October 1998.

104 See Staff Reporters, 'Government Urged Not to Sit on Boards,' South China Morning Post, 27 October 1998.

105 See Mukul Minish, 'Firms Buck SAR Board Seat Plans,' Hong Kong Standard, 30 October 1998.

106 Michael C Davis suggests that the fundamentals of 'constitutionalism' include three core institutional components: democratic elections with free and fair multiparty contestation; human rights and freedom of expression; and the rule of law, including adherence to principles of legality. See 'constitutionalism and East Asian Economic Development' (December 1998, on file with author), p.3

107 The introduction of EFIL as a new institutional actor has fundamentally changed the operation of Hong Kong's financial sector. This is illustrated by recent reports that officials of Shanghai Industrial Holdings, in which the government holds an 8.49% stake, consulted with some board members of the EFIL (on an informal basis) before deciding to amend the company's hotel purchase plan. See Enoch Yu, 'EFIL Consulted over Cancelled Purchase,' South China Morning Post, 15 December 1998.
Executive's rhetoric in his October Policy Address stressing his commitment to transparency and accountability in the governance of Hong Kong.\footnote{The EFIL will be around for a long time to come, particularly now that the EFIL has also been given the mandate to manage the government’s HK$12b equity portfolio previously held by the Land Fund. Given the government’s institutional choice and commitment to establishing the EFIL, it will be extremely difficult for the government to backtrack and dismantle the EFIL. See Davis (note 106 above), p 19 (discussing the links between economic reform and democracy and the institutions of constitutional government).}

\textit{Discretionary emergency powers given to Chief Executive}

Of questionable merit is the proposal to grant greater powers for the Chief Executive, when public interest was under threat, to direct the SFC, as well as the exchanges and the clearing houses.\footnote{At this point, it is not clear what circumstances will constitute the public being under threat to warrant the exercise of the Chief Executive’s power. See discussion in Sprague (note 4 above), p 68.} Despite the government’s earlier commitment to strengthen the supervisory capacity of the SFC, this proposal subordinates the SFC to the supervision of the Financial Services Bureau and indicates a breakdown in relations between the government and the SFC. Granting such discretionary directive power to the appointed head of the government (even if only in a public emergency) undermines the effectiveness of the regulatory authority of the SFC and is a challenge to the legitimacy of the SFC as an independent authority regulating Hong Kong’s financial markets. Moreover, it is completely out of step with the international trend in stock market regulation to vest clear and objectively stated powers of market regulation on an operationally independent but publicly accountable market regulator.\footnote{See comments in this regard by Neoh (note 73 above), p 5. Mr Neoh noted that the need for clear and objectively stated regulatory powers and for operational independence and public accountability of the market regulator is also recognised in IOSCO’s Objectives and Principles of Securities Regulation. However, the government appears to be pressing ahead with the proposal to increase the Chief Executive’s power over the securities and futures market despite objections from the SFC. See Enoch Yiu, ‘Government Snubs SFC over Wider Chief Executive Powers in Markets,’ South China Morning Post, 19 February 1999.} Despite the government’s publicly stated intention to reform and upgrade Hong Kong’s regulatory framework to international standards in order to maintain and protect the integrity of Hong Kong’s financial markets, this proposal falls short of any such international standards by removing the independence and public accountability of market regulators.

The full ramifications of this hastily drafted proposal have clearly not been considered, no doubt in part due to time constraints. The Chief Executive, the appointed political head of the government, can effectively dictate trading rules that must be implemented by the SEHK, HKFE, and HKSCC. The legitimacy of the proposal is questionable since there are few, if any, apparent limits on the Chief Executive’s exercise of such discretionary powers. Although the Chief Executive claimed in his Policy Address that it is not the intention of the government to expand its own powers, that is precisely the result of
granting such discretionary emergency powers to the Chief Executive.\textsuperscript{111} Are Hong Kong's financial difficulties to be used as an excuse for increasing the authoritarian practices of the government and the potential for administrative arbitrariness concerning Hong Kong's financial policies?\textsuperscript{112}

While the answer to this question remains to be seen, the proposal is clearly contrary to the government's stated policy of not directing — but merely 'facilitating' — the development of Hong Kong's financial markets.\textsuperscript{113} The government's statements emphasising the need for 'stability' in Hong Kong's financial markets may be interpreted as the government's desire for greater 'control' over Hong Kong's economy. Moreover, vesting the Chief Executive with broad discretionary power to direct Hong Kong's financial markets (with few limitations on the exercise of such power) is in keeping with Chief Executive Tung Chee-hwa's paternalistic style of governance and lack of policy consultation to date.\textsuperscript{114} In this sense, the proposal to broaden the Chief Executive's powers to direct Hong Kong's financial markets has a fundamental constitutive status.\textsuperscript{115} The proposal is an unfortunate move towards an authoritarian orientation rather than a democratic orientation in financial policy-making within Hong Kong.\textsuperscript{116} The proposal is troublesome because it increases the propensity of the Chief Executive to govern by what Roberto Unger characterises as the 'commands of the sovereign' under a bureaucratic or regulatory legal system rather than a legal system associated with the rule of law ideal.\textsuperscript{117} The effective result of the proposal is a move away from a rule-based legal system to a more bureaucratic system of governance marked by the

\textsuperscript{111} See note 30 above, para 8.

\textsuperscript{112} In this regard, consider the comments of Michael Davis concerning the impact of the Asian financial crisis on authoritarian development models in Asia — is the crisis evidence of the failure of authoritarian developmentalism or an excuse for persisting in authoritarian practices? See note 106 above, in which Davis argues that the current financial crisis points to the need for liberal constitutional reform.

\textsuperscript{113} See statements of the government in the April 1998 Report (note 18 above). Under this proposal, there is potential for considerable government interference with Hong Kong's financial markets which may increase investor anxiety in the future.

\textsuperscript{114} See further discussion below.

\textsuperscript{115} Another example of financial and monetary policies taking on a fundamental constitutive status is the decision of the Malaysian Prime Minister Mahathir to impose severe foreign exchange controls. If these measures persist for a long time, they will dramatically change Malaysia's economic structure. See discussion of this point by Professor Davis (note 106 above), p 26.

\textsuperscript{116} Ultimately, the Chief Executive may be able to issue policy directives impacting upon Hong Kong's economic and financial laws in Hong Kong — in other words, law may become subservient to policy decisions made by the Chief Executive. Since under Art 45 of the Basic Law the Chief Executive is appointed by the Central People's Government of the PRC (the CPG), what prevents the CPG from pressurising the Chief Executive to greater and greater state intervention in Hong Kong's economy? See general discussion of this issue in Stanley Lubman, 'Chinese Administrative Law and the Challenges of Chinese Law Reform' (1 December 1998, on file with author), pp 22-4.

exercise of discretionary powers with few effective constraints.\textsuperscript{118} Furthermore, the proposal granting the Chief Executive such broad discretionary powers to direct Hong Kong's financial markets has the potential to undermine the central importance of the rule of law as a necessary condition for Hong Kong's long-term economic growth.\textsuperscript{119}

Conclusion

The final economic analysis of the merits of the government's intervention in Hong Kong's financial markets — was it a shrewd investment or a reckless gamble? — remains to be seen. Irrespective of whether the intervention proves to be good or bad news for the stock market, however, it has created a number of problems that will have a long-lasting impact on Hong Kong's financial markets generally and on Hong Kong's role as an international financial centre. Despite the government's attempts to minimise the conflicts of interest created by its intervention in the markets, the fact remains that it is both a major shareholder in many listed Hong Kong companies and at the same time the regulator of Hong Kong's financial markets. Moreover, the conflicts of interest have not been remedied by the formation of the EFIL to manage the government's substantial equity portfolio, particularly given the heavy involvement of the HKMA in the administration and operation of the EFIL. The ability of the EFIL to make investment decisions independent of some degree of government influence is questionable.

Notwithstanding the problems inherent with the EFIL, a more difficult issue the government will have to deal with is damage resulting to the administration's credibility and authority to govern. The government's handling of the financial crisis and its intervention in the stock market have dealt a blow to the confidence of the investing public (both domestically and internationally) in the financial regulators and the government.\textsuperscript{120} The intervention has raised


\textsuperscript{119} Douglass North and his theory of new institutional economics emphasises the importance of the institutional environment for economic growth and the need for the rule of law (referring generally to security of property rights and effective contract enforcement) as a necessary condition for a state's long-term economic development. See Douglass North, Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press, 1990) and discussion in Chen (note 118 above), at pp 9-10.

\textsuperscript{120} See James Leung, 'The End of a Free Market,' Asian Business, October 1998, p 42. A report by a private consulting group, Political and Economic Risk Consulting, in August 1998 indicated that public confidence in the HKSAR government has been eroded due to inept handling of the economic crisis and other domestic issues such as the clumsy handling of Chinese language education, the avian flu scare, and the bungled opening of the new airport in July 1998. See David Saunders, 'Public Confidence Eroded, Survey Finds,' South China Morning Post, 20 August 1998.
suspicions that, if the government can abandon its long-standing free market policy in the financial markets, it may do so in other areas.\textsuperscript{121} More importantly, the crisis has called into question the style of governance of the Chief Executive Tung Chee-hwa.\textsuperscript{122} Neither the Executive Council nor LegCo was consulted by the Chief Executive or the Financial Secretary about the decision to launch Operation Purchase in August — one of the biggest policy decisions in years.\textsuperscript{123} Furthermore, the crisis has injected further tension into the already strained relationship between the Chief Executive and Hong Kong's Legislative Council. Since the handover, the Chief Executive has visited LegCo on only limited occasions and has held very few policy consultations with legislators.\textsuperscript{124} Certainly there was no consultation with LegCo prior to the launch of Operation Purchase in August.\textsuperscript{125} Members of LegCo have openly criticised the Chief Executive for lacking vision and long-term strategy for Hong Kong and recently refused to give the Chief Executive the customary vote of thanks after his second annual Policy Address.\textsuperscript{126}

It is imperative that the relationship between the appointed Chief Executive and the independent market regulator — the SFC — be reviewed in light of the proposal to grant the Chief Executive powers to direct the exchanges in Hong Kong. The long-term ramifications of giving such discretionary powers to the Chief Executive, the political head of government, merit further review and reconsideration. If the government truly wants to consolidate Hong Kong's ability to manage its financial affairs (as it claims), it must undertake a comprehensive review of the function and powers of the HKMA, SFC, SEHK, HKFE, and HKSCC and their relationship with a view to enhanced co-

\textsuperscript{121} For example, Martin Lee, leader of the opposition Democratic Party, questioned the Financial Secretary at the 7 September session of LegCo as to why the government failed to act earlier in the economic crisis and the real reason behind the government's intervention. See Hoi Leung (note 44 above).

\textsuperscript{122} Popular opinion views the Chief Executive as increasingly out of touch with the people of Hong Kong and less accountable and more patriarchal in style of governance. See Editorial, The Economist, 28 November 1998, p 25 (noting the lack of policy discussion and debate between the Chief Executive and the civil service lead by Anson Chan) and Ho (note 34 above), p 37.

\textsuperscript{123} Operation Purchase was presented to LegCo as a 'done deal.' In fact, nearly all of the government's major initiatives have been adopted with minimal consultation. The recent economic crisis has also focused the public's attention on the competence and quality of Hong Kong's civil service to govern the SAR. See Sin-Ming Shaw, 'The Leadership Gap,' Newsweek, 12 October 1998, p 29 (noting that Hong Kong's civil service failed to measure up in terms of education and training when compared to the civil service in Singapore and Taiwan).


\textsuperscript{125} Arguably LegCo should have been briefed more thoroughly in the event of another 'attack' by speculators and the potential need to furnish appropriate more public funds. See comments of legislators in this regard to the Financial Secretary at a meeting of LegCo's Financial Affairs Panel on 7 September 1998 (note 27 above), paras 26-9.

\textsuperscript{126} The only other time this was done was in relation to one of former Governor Patten's policy addresses. Public reaction to the Chief Executive's policy address was generally negative, asserting that it failed to offer solutions to the problems facing Hong Kong. See Chris Yeung, 'Tung Fails to Offer Solutions,' South China Morning Post, 8 October 1998.
ordination between these regulatory bodies.\textsuperscript{127} To substantiate the rhetoric of the Chief Executive in his Policy Address (and that of Sir Donald Tsang, Financial Secretary, and Joseph Yam, Chief Executive of the HKMA), the government must take clear and decisive action to improve the regulatory framework of Hong Kong's financial markets.

Hong Kong is facing stiff competition from other international markets, with Singapore revamping its regulatory system to challenge Hong Kong as a leading international financial centre in Asia.\textsuperscript{128} Rather than piece-meal reforms introduced as part of an ad hoc reaction to the recent financial crises, reform should be part of a rational and comprehensive process.\textsuperscript{129} It is important to consider the recent market failures in Hong Kong in a wider perspective and not simply react immediately with short-sighted regulation proposals.\textsuperscript{130} Central to this reform process should be the desire to maintain the integrity of Hong Kong's financial markets and the investing public's confidence in those markets.

\textsuperscript{127} See discussion of this point by Ho (note 34 above), pp 18-19. There has been discussion of co-ordination by a 'super-regulator' modelled after the UK's Financial Services Authority which supervises the entire financial services sector in the UK, although this appears to have been vetoed by the new SFC Chairman. See comments by SEHK Chairman Lee Hon-choi in Hoi Leung, 'Super Financial Watchdog on Way,' Hong Kong Standard, 31 October 1998.

\textsuperscript{128} In 1996 Singapore announced it would liberalise its international and domestic market from April 2000 onward. More recently in November 1998 Singapore unveiled measures to make itself more economically competitive and subsequently on 23 November the Singapore International Monetary Authority (SIMEX) launched a rival Hong Kong index futures product with data supplied by Morgan Stanley Capital International. Under increasing pressure, the HKSAR government announced in late November that it is drafting a plan to boost its competitive edge as a regional financial hub in the face of mounting threats from Singapore. For discussion of this issue, see Cesar Bacani, 'Who Has the Edge? Hong Kong Versus Singapore,' Asia Week, 27 November 1998, p 60.

\textsuperscript{129} It is encouraging to note the comments of the SFC Chairman in December 1998 regarding plans to introduce 'radical reforms' in Hong Kong in 1999 to bring Hong Kong into line with international standards and enhance its ability to compete. See Andrew Sheng, 'Chairman's Year-end Remarks,' 30 December 1998, available at <http://www.hksfc.org.hk/eng/press/98/8apr20.htm> and Enoch Yiu, 'SFC in Push for Radical Reforms,' South China Morning Post, 31 December 1998.

\textsuperscript{130} In this respect, the reform process undertaken by the SFC and the government must be broadened and further enhanced with the enactment of a revised Composite Securities and Futures Bill giving the SFC broad regulatory powers over all institutions engaged in Hong Kong's securities industry (including banks). While it is understood that LegCo has allocated a slot for consideration of this Bill in 1999, further reform is urgently needed to improve the regulatory framework for Hong Kong's financial markets. See SFC Consultation Paper on a Draft for a Composite Securities and Futures Bill, June 1997 (available at <http://www.hksfc.org.hk/eng/consult/bill.htm>.)
### Appendix

**THE HONG KONG SAR GOVERNMENT'S EQUITY PORTFOLIO**

<table>
<thead>
<tr>
<th>Name of Company</th>
<th>Percentage of Company Held</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swire Pacific</td>
<td>12.28</td>
</tr>
<tr>
<td>New World Development</td>
<td>11.91</td>
</tr>
<tr>
<td>Cheung Kong (Holdings) Ltd</td>
<td>10.34</td>
</tr>
<tr>
<td>HSBC Holdings Ltd</td>
<td>8.8</td>
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<tr>
<td>China Resources Enterprises</td>
<td>8.78</td>
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<tr>
<td>TVB</td>
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<tr>
<td>Shanghai Industrial Holdings</td>
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<tr>
<td>Hong Kong Telecom</td>
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<tr>
<td>Sun Hung Kai Properties</td>
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<tr>
<td>Hutchison Whampoa</td>
<td>7.86</td>
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<td>CITIC Pacific</td>
<td>6.9</td>
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<tr>
<td>Hong Kong &amp; China Gas</td>
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<tr>
<td>Guangdong Investments</td>
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<tr>
<td>Hong Kong Electric</td>
<td>6.15</td>
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<tr>
<td>Bank of East Asia</td>
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<tr>
<td>First Pacific</td>
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<tr>
<td>Hysan Development Co</td>
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<tr>
<td>Hang Seng Bank</td>
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<td>CLP Holdings</td>
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<tr>
<td>Wharf Holdings</td>
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<tr>
<td>Hong Kong &amp; Shanghai Hotel</td>
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<tr>
<td>Henderson Land</td>
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<tr>
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<td>Shangri-La Hotels</td>
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<tr>
<td>Hang Lung Developments</td>
<td>2.5</td>
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<tr>
<td>Amoy Properties</td>
<td>2.49</td>
</tr>
</tbody>
</table>

Source: South China Morning Post, 27 October 1998, citing Exchange Fund Investment and Bloombergs