Report of Inquiry

Dealings in HSBC Holdings Plc Shares

29 and 30 October 1997

Hong Kong

August 1998

Published by
Securities and Futures Commission
12th Floor, Edinburgh Tower
The Landmark, 15 Queen's Road
Central
Hong Kong
Tel : 2840 9222
Fax : 2521 7836
E-mail address : enquiry@hksfc.org.hk
Website : http://www.hksfc.org.hk

Contents

Introduction

1. The Securities and Futures Commission ("SFC") has conducted an investigation into dealings in the shares of HSBC Holdings Plc ("HSBC") on 29 and 30 October 1997 under sections 31 and 33 of the Securities and Futures Commission Ordinance ("SFCO"). From this investigation, the SFC has concluded that there is no evidence that any persons involved acted improperly. However, the Financial Secretary is of the view that, "given the public and media attention on the matter, it is desirable to publish the SFC¡¦s findings to help dispel public misapprehension that the high level of selling of HSBC shares might have been connected to abuse of insider or non-public information and that justice can be seen to be done".

2. Accordingly, the SFC is hereby publishing a summary of the findings of its inquiry. In the circumstances of the case, in view of the fact that there is no evidence of wrong-doing or of inappropriate behaviour, the confidentiality of the parties concerned in commercial transactions is being respected, and their identities not disclosed herein. The Secretary for Justice has consented to publication of this report.

Background

3. HSBC opened trading on Monday, 27 October 1997 at a price of HK$199.00 and closed at HK$185.50. Following a 4% drop in the Dow Jones Index that night, the price of HSBC fell to a low of HK$149.00 and closed at HK$155.00 on Tuesday, 28 October 1997. A sharp rebound occurred on 29 October 1997 when the share price of HSBC rose to HK$192.00 before closing at HK$188.00.

4. Before 11 a.m. on Thursday 30 October 1997, HSBC shares traded in the range of HK$177.00 to HK$180.00. At 11:02 a.m. Moody's Investors Service ("Moody's") issued a statement which downgraded the outlook of Hong Kong banks and placed the rating of HSBC and its subsidiary, Hang Seng Bank, on review for a possible downgrading ("the Moody's announcement"). After the release of this statement, HSBC¡¦s share price dropped from around HK$180.00 to a low of HK$167.00, before gradually recovering to close the day at HK$173.50. On Friday, 31 October 1997, the price of HSBC fluctuated between HK$167.00 and HK$178.00.

5. During trading on 29 October 1997 and on the morning of 30 October 1997, the Stock Exchange of Hong Kong Ltd ("SEHK") reported a significant increase in short sales of HSBC shares.

6. During the two days prior to Moody's announcement, there were press articles in which there were bearish forecasts about HSBC and speculation that the price of the bank's shares would fall. The forecasts were based on a belief that HSBC's profits would fall significantly because of the increasing need for provisions to be made for bad debts. There were also market rumours that HSBC would lose its status as a note-issuing bank in Hong Kong.

7. After the Moody's announcement, there was press speculation concerning the possible leakage of the information contained in the Moody's announcement prior to its official release. The press linked this possibility to the short selling actually seen in HSBC shares on 29 October 1997 and 30 October 1997 on SEHK.

The SFC's investigation

8. According to information supplied by SEHK, there were four brokers short-selling HSBC shares on 29 and 30 October 1997. Pursuant to an inquiry conducted under section 31 of the SFCO, the SFC required these brokers to disclose the identities of their clients.

9. To identify those selling HSBC shares on 29 October 1997, and prior to the Moody's announcement on 30 October 1997, an inquiry was mounted under section 31 of the SFCO. This inquiry covered 80% of trading in HSBC shares on both days. The remaining 20% was considered insignificant given it was scattered amongst many brokers trading less than 40,000 shares.

10. Activity in the 22 derivative warrants on HSBC was also considered. Trading in relation to 5 derivative warrants, selected randomly, was reviewed. There was no significant trading in these 5 warrants on either 29 or 30 October 1997. Therefore, it was concluded that no further inquiries were necessary in relation to trading in derivative warrants on HSBC.

11. The section 31 inquiry identified only three major traders who sold large quantities of HSBC shares on both days. As a result of these findings, and given media speculation concerning the possible leakage of the Moody's announcement prior to its issue, an inquiry was commenced under section 33 of the SFCO based on the belief "persons dealing in the shares of HSBC may have engaged in dealing in such shares on 29 or 30 October 1997 in a manner which was not in the interest of the investing public or the public interest". The investigation was not based on the belief that "insider dealing" in HSBC shares may have occurred as the situations in which insider dealing can occur under the Securities (Insider Dealing) Ordinance do not appear to encompass trading based on leakage of information from a rating agency such as Moody's. Under section 33 of the SFCO, parties involved are compelled to provide information to an investigator.

Results of the investigation

Inquiries with Moody's Investors Service

12. Moody's New York office, in a letter of 30 January 1998, provided a sequence of events leading to the Moody's announcement, including details of persons involved at each stage.

13. In relation to the announcement, Moody's confirmed that nobody within the HSBC Group was contacted in the preparatory stages leading to the finalised version of the Moody's announcement. They confirmed that the issuer would only be informed of a rating change shortly before its release to the public. In this regard, the first contact with HSBC concerning the Moody's announcement was when HSBC was verbally advised of the rating change at 10:35 a.m. on 30 October 1997 shortly after which a copy of the Moody's announcement was faxed to the bank. Moody's also pointed out in correspondence that "Moody's Code of Ethics, Standards of Professional Conduct, and Securities Trading Policy prohibit the disclosure of, or trading in securities upon, material non-public information in Moody's possession and impose severe penalties for violations."

14. Those involved in the process leading to the Moody's announcement were compared with those identified in the section 31 inquiry conducted in relation to the sale of HSBC shares. No connection was established.

Sales by Company A

15. Company A is a company incorporated in the British Virgin Islands and is a wholly owned (investment dealing) subsidiary of a Hong Kong listed company (Company AA). The SFC investigation indicated that Company A commenced accumulating HSBC shares in April 1997.

16. On 29 October 1997, there was a morning meeting to discuss the investment held by Company A and methods of reducing the holding company (Company AA) debt were discussed. Given the high interest rates at that time, it was decided to sell some HK$1 billion shares to lessen the interest rate burden. As HSBC shares were the most liquid stock in their portfolio, they were chosen to be sold.

17. To give effect to the decision, brokers were instructed to sell HSBC shares on 29 and 30 October 1997 "at market". On 29 October 1997, 3,702,400 HSBC shares were sold and on 30 October 1997, 2,627,600 HSBC shares were sold.

18. Immediately after these sales a total of HK$1,132 million (being the net proceeds of the sales) was paid to Company A and applied to reduce its parent company (Company AA) indebtedness and to meet part of a cash requirement of a project in which the parent company was involved.

19 From the above enquiries the SFC concluded that the sales of HSBC shares by Company A were based on a commercial decision given the prevailing circumstances of its parent company.

Dealings by Company C

20. Company C, a company incorporated in the British Virgin Islands, is a wholly owned subsidiary of Company CC, a Hong Kong listed company (neither are connected in any way with Company A or Company AA above).

21. The section 31 inquiry established that Company C short sold the following HSBC shares through a broker (Broker D) :

Date	No. of shares	Average price
29 October 1997	3.1 million	HK$181.44
30 October 1997	1.0 million	HK$178.06

22 It also found that Company E (an affiliate of another broker) sold the following HSBC shares :

Date	No. of shares	Average price
29 October 1997	2.97 million	HK$182.67
30 October 1997	2.00 million	HK$174.38

23. Company C had 26 short put options contracts on HSBC shares outstanding as at close of business on 28 October 1997. These included 11 contracts with Broker D representing 4.1 million HSBC shares and 11 contracts with Company E representing 7.8 million HSBC shares. These (short put) contracts were unhedged as, although Company CC through various subsidiaries, had previously held HSBC shares, these had all been sold to cover other short put options.

24. A short put option is an agreement to buy, at a future date, from a counterparty a quantity of shares at a set price ("the strike price") in anticipation of the share price rising. The counterparty to the agreement has a long put option and pays a premium for the right to sell the shares at the strike price. The premium is based on the price and volatility of the underlying shares, the life span of the option and prevailing interest rates. In the case of the short put options referred to in paragraph 23, Company CC had effectively contracted to buy HSBC shares at prices ranging from $217 to $277.

25 In view of the exposure created by these unhedged short put options, and seeing the market falling with the expectation this may continue, Company CC short sold HSBC shares (using Company C as the dealing vehicle). 4.1 million HSBC shares were sold through Broker D and swap transactions on 5 million HSBC shares were entered into with Company E. From the perspective of Company C, the swap was equivalent to entering into transactions to short sell 5 million HSBC shares. As a result of the swap, Company E sold about 5 million HSBC shares on 29 and 30 October 1997, as these shares were no longer required for hedging purpose. The short sell and swap of a total of 9.1 million HSBC shares was aimed at preventing any further losses which may have resulted from further volatility in the stock market. In addition, Company CC also entered into 5 long put options with a third party broker to further reduce exposure arising from its open short put options.

26. This explanation is supported by records and information provided by Company CC; the records of the brokers concerned and by information supplied by Company E.

27. In regard to Company E, it was confirmed that, as principal, it had sold around 5 million HSBC shares on 29 and 30 October 1997. These shares were held previously by Company E to hedge the long put

options on HSBC shares. The 5 million HSBC shares sold was done as result of a 'swap' with an unnamed client(s) to cover that client(s) further losses caused by the fall in price of HSBC shares. From Company C's records, it can be concluded that Company E's unnamed client was Company C.

28. The activity by Company CC on 29 or 30 October 1997 to sell HSBC shares was to protect the company from the exposure arising from the short put options and the potential additional trading losses which may have resulted from further volatility in the stock market.

29. Those identified in the dealings referred to in paragraphs 15 to 28 above all denied any knowledge of the Moody's announcement before its issue. None could be connected to those involved in the events leading to this announcement.

Other Brokers

30. The records of three other brokers involved in short selling HSBC shares were examined. The quantities involved were relatively small, and related either to sales on behalf of clients or the hedging of arbitrage activities or of the holdings of listed derivative warrants. There was also no apparent connection between those trading and those privy to the Moody's announcement prior to its issue.

Conclusion

31. Prior to the Moody's announcement there was considerable speculation concerning the future profits of HSBC and the provisions it might have to make for bad debts resulting from the financial turmoil being seen in North and South East Asia at that time. Indeed the price of HSBC shares had already fallen significantly on 23 October 1997 (from a close of HK$218 on 22 October 1997 to a close of HK$188.50 on 23 October 1997, a 13.53% fall against a fall in the Hang Seng Index of 10.40%). This speculation occurred before Moody's commenced its consideration of a possible downgrading of HSBC's credit rating on 28 October 1997 (10 p.m. Hong Kong time). In general, market sentiment was extremely poor and Hong Kong dollar interest rates were rising dramatically.

32. Given this scenario, the explanations concerning the substantial sales of shares by Company A to reduce parent company indebtedness and by Company CC (through its subsidiary Company C) to reduce its exposure to short put option are logical and commercially and economically justifiable. Indeed, at that time, and given the situation in North and South East Asia, it could have been argued that even more significant falls in the Hang Seng Index could be anticipated, and that interest rates would remain at high levels for a considerable period to support and maintain the HK$/US$ peg which was under pressure. This is basically the view apparently taken by Company AA. In this context it needs to be recognized that at a time of financial crisis it is the most liquid stocks that are most likely to be subject of forced selling.

33. Moody's has confirmed that prior to their announcement of 30 October 1997 great care was taken to ensure no information was disclosed to any third party, and that HSBC itself had only been approached half an hour before the issue of the Moody's announcement. It pointed to its Code of Conduct that would result in severe penalties if any employee of Moody's disclosed confidential information.

34. Moody's confirmation that its downgrading was kept confidential prior to its announcement is supported by the fact that none of those selling HSBC shares, or who instigated these sales, or were involved in the sales in any way could be connected to those involved in Moody's and all denied any knowledge of Moody's announcement prior to its issue. There are also independent reasons that fully account for the decisions by the major sellers to justify their action.

35. It is concluded that there is no evidence that any of those selling substantial quantities of HSBC shares on 29 or 30 October 1997, or those identified as short selling HSBC shares on either day, were privy to information contained in the Moody's announcement prior to its issue. There is also no indication that any of the brokers involved had acted improperly.

August 1998

Page last updated: 7 November 2001