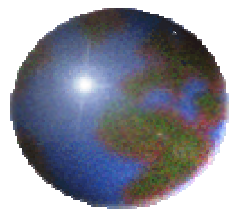




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Regulating an Integrated Demutualized Exchange
*The Hong Kong Experience**

Andrew Sheng
Chairman
Securities and Futures Commission
Hong Kong

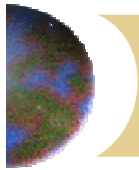
Background

- ✦ The Stock Exchange of Hong Kong (SEHK), Hong Kong Futures Exchange (HKFE) and their clearing houses merged to form the Hong Kong Exchanges and Clearing Limited (HKEx) in March 2000
- ✦ HKEx (as a holding company) was listed on the SEHK in June 2000
- ✦ The Exchanges and Clearing Houses (Merger) Ordinance 2000 (ECHMO) was passed to facilitate merger

Regulation of HKEx

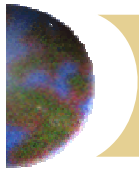
Profit vs Public interest role:

- as public utility
 - ownership
 - corporate governance
 - external regulation
- as monopoly provider of trading platforms and clearing
- as regulator
 - potential competitor/cooperator with exchange participants
 - listing frontline regulator (FLR) and listed company



Ownership of HKEx

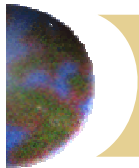
- ❖ SEHK retains monopoly as only stock exchange in HK with physical trading floor. HKFE does not have monopoly under ECHMO.
- ❖ Only recognized exchange controller (REC) can control exchange or clearing house
- ❖ Interest of REC in exchange or clearing house cannot be varied without SFC approval
- ❖ Shareholding of 5% or more in REC requires approval of SFC (after consultation with Financial Secretary (FS))
- ❖ FS can grant exemption under specific conditions (e.g. mergers, alliances)



ECHMO obligations on HKEx

HKEx to:

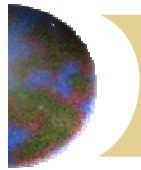
- ❖ ensure orderly and fair markets
- ❖ ensure risks of exchanges, clearing houses are managed prudently
- ❖ ensure exchanges, clearing houses comply with requirements
- ❖ act in interests of the public and ensure they prevail in case of any conflict
- ❖ Constitution and rule amendments require SFC approval
- ❖ SFC can require rule amendments, suspend functions, close exchanges



Management of Systemic Risks

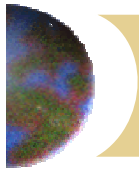
HKEx Risk Management Committee

- ❖ Statutorily created to formulate policies on risk management matters relating to the HKEx and its exchanges and clearing houses
- ❖ chaired by HKEx Chairman
- ❖ includes ex-officio Chairman SFC and Chief Executive of Hong Kong Monetary Authority
- ❖ 1 to 3 members appointed by Financial Secretary
- ❖ 2 members appointed by the HKEx Board
- ❖ Advises HKEx Board on risk management issues



Regulation of HKEx

- ❑ Fees imposed by HKEx in “its capacity as” REC, exchange or clearing house require SFC approval
- ❑ SFC to have regard to:
 - level of competition, if any, in Hong Kong, for relevant matter
 - similar fees of overseas exchanges etc
- ❑ SFC primarily concerned with: avoidance of monopoly abuse (excessive or predatory fees); undue discrimination between market participants
- ❑ No express regulation of other aspects of monopoly



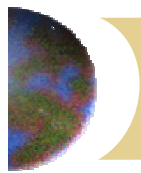
Current Frontline Regulator of Listed Companies

- ✿ Present structure dates back to Ian Hay Davison report of May 1988, following 1987 crash: statutory role with SFC, but SEHK always undertook listing functions

- ✿ 1991 MOU governing listing matters between SFC and SEHK sets out the division of responsibilities
 - ❖ Delegated front-line listing role to SEHK
 - ❖ amended and restated in March 2000 upon demutualization of SEHK

MOU with SEHK

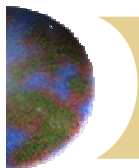
- ✦ SEHK is the “frontline regulator” of the listed corporate sector - “solely responsible for the day-to-day administration of all listing-related matters”
- ✦ SFC is to supervise and monitor (“oversee”) SEHK in the performance of its listing related functions
- ✦ SEHK board delegated all listing related functions and powers to a Listing Committee comprised of market practitioners and participants
- ✦ Listing Committee delegated certain administrative and routine functions to staff of SEHK Listing Division
- ✦ *SFC administers Takeovers Code and investigates suspected insider dealing, market manipulation and violation of statutory disclosure requirements*



Conflicts of Interest in Listing HKEx

❁ S.14 of the ECHMO:

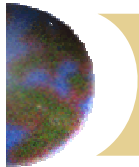
- ❁ SFC can give directions to avoid potential conflicts of interest between interests and proper performance of HKEx's regulatory functions
- ❁ directions can relate to affairs, business or property
- ❁ power not restricted to listing conflicts
- ❁ right of appeal to Chief Executive in Council



Safeguards against Conflicts of Interest

❁ S.13 of the ECHMO:

- ❁ before listing of HKEx, SFC must be satisfied that rules and arrangements are in place
 - to deal with possible conflicts of interests
 - to ensure integrity of the securities and futures markets
 - to ensure compliance by HKEx with its obligations as a listed company
- ❁ SFC regulates HKEx as a listed company instead of SEHK



Practical safeguards

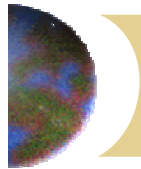
✿ S. 13 and S. 14 safeguards include:

- ✦ formation of the SFC (HKEC Listing) Committee and the SFC (HKEC Listing) Appeals Committee to handle
 - listing matters re HKEx
 - listing matters of other companies which are either a business competitor or business associate of the HKEx group
- ✦ the SFC (HKEC Listing) Executive assuming day-to-day regulation of HKEx in relation to listing matters
- ✦ pre-listing MOU between the SFC, HKEx and the SEHK to deal with possible conflicts of interests
- ✦ Chapter 38 of the Listing Rules applies to HKEx

Weaknesses in Existing Structure

- ✿ SEHK administer non-statutory listing rules as a matter of contract and have no statutory enforcement power

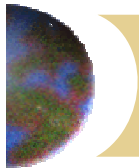
- ✿ SEHK's "profit versus regulation" conflict of interest:
 - ✦ Obligation to shareholders to maximise revenue (by allowing more listings) and minimise cost (by devoting less resources to regulation)
 - ✦ Increasing confusion over the use of listing rules in branding, business promotion, quality assurance and role of regulation for investor protection
 - ✦ Listed company cannot be tough on regulation if legal suits lead to drop in share price
 - ✦ Chinese wall between business and regulatory units lead to communication gaps



Emerging Stresses

- ✦ As HKEx expands business, increasing conflict of interest with listed companies
 - ✦ Regulation of listed affiliates or competitors of HKEx involving potential conflicts of interest are referred to SFC
 - ✦ Currently SFC regulates 2 other companies with which HKEx has potential conflicts
 - ✦ Potential conflict of interest in companies HKEx is suing for overdue fees

- ✦ Split regulation is confusing to the public
 - ✦ How can the Board does not know what is happening on the regulatory side? [Because of Chinese wall!]
 - ✦ Regulator regulating another regulator
 - ✦ Will the real regulator please stand up?



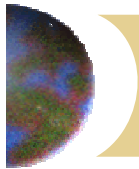
Recent developments

❁ Dual filing wef 1 April 2003

- ❁ New Securities & Futures Ordinance subsidiary legislation makes SFC statutory regulator of listed company disclosure, designed to address lack of enforcement power of SEHK Listing Rules
- ❁ Listing applicants and listed issuers to dual-file listing application/disclosure document to SFC
- ❁ Persons who intentionally or recklessly make false and misleading disclosure will attract statutory liability and be subject to SFC's enforcement actions
- ❁ Compromise solution does not address lack of clarity between roles of SFC and SEHK

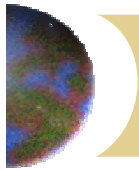
Aftermath of Penny Stock Incident

- ✿ Panel on Penny Stock Incident, July 2002, recommended review of listing structure
- ✿ Expert Group to review the operation of the securities and futures market regulatory structure
 - ✿ Appointed by the Government in September 2002
 - ✿ 3 member group headed by Mr Alan Cameron
 - ✿ To review the operation of the regulatory structure as regards listing matters and to recommend changes and improvements where appropriate
 - ✿ Report due by end of March 2003



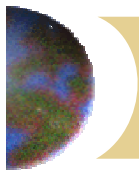
Internal Checks and Balances

- ❑ Separate HKEx Divisions for Listing, Regulation and Risk Management
- ❑ Reports directly to CEO, RMC and Listing Committee (independent of the Board)
- ❑ “One way” Chinese Wall with HKEx Business Units
- ❑ Review by Internal audit
- ❑ Separate liaison with SFC



Regulatory Rationalization

- ❖ Exchanges no longer have the role as SRO of exchange participants
- ❖ Phase 1: SFC took over administration and enforcement of financial resources rules and conduct requirements
- ❖ Phase 2: Conduct and prudential matters moved from Exchange Rules to SFC Rules and Codes
- ❖ MOU entrenches arrangements and provides for greater information flow from SFC to Exchanges



Intermediaries Supervision

SFC primarily responsible for prudential and conduct regulation of the Exchange Participants including :

- ❑ conducting routine inspection of business
- ❑ monitoring compliance with conduct rules
- ❑ monitoring compliance with financial resources rules
- ❑ ensuring proper internal controls
- ❑ investigate and discipline intermediaries for misconduct

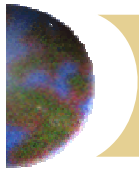
HKEx retains contractual relationship of user supervision to

- ❑ manage risk exposure of its business units
- ❑ ensure compliance with trading rules

Market Surveillance

HKEx's surveillance functions are more business oriented and focus on trading operations and risk management:

- ❑ enforcement of trading and clearing rules
- ❑ front-line monitoring of trading activities
- ❑ maintenance of market transparency
- ❑ monitoring clearing house risk and business risk
- ❑ interacting with market participants
- ❑ monitoring cross-market activities of HKEx market users



SFC role in Market Surveillance

SFC primarily responsible for detecting market malpractice:

- ❑ monitor market movements to detect breaches of laws
- ❑ conduct investigations of suspected breaches
- ❑ oversee surveillance actions of HKEx
- ❑ perform cross-market surveillance

Side effects

- ❑ HKEx no longer a member association:
 - HKEx lobbying restricted to its business interests
 - emergence of new industry representative bodies
 - no “industry” or “market” view on e.g. Securities and Futures Ordinance
 - much more direct liaison between SFC and industry groups
- ❑ Absence of SRO means no “peer review” of Exchange Participants:
 - increased transparency and accountability of SFC (Process Review Panel, Securities & Futures Appeals Tribunal, User Working Groups, Advisory Committee)

Pressure Points

- ❑ Clearing/Central Counterparty
 - Natural monopoly, utility, central source of systemic risk → debate on government/user/privately-owned, tight regulation
 - but value chain unbundling and contestable
- ❑ Ancillary services - depository, custody, registry, technology, back-office support
 - antitrust and fair competition issues
 - regulation of fees?
- ❑ Information provision (trading and corporate information)
 - fair access to competitors and public
 - level of charges



Pressure Points (2)

Cross-Border Issues

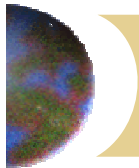
- ❑ If exchange is not an SRO, how to regulate remote members?
- ❑ Regulation of mergers and alliances
 - coordination between regulators, legal systems
 - impact on checks and balances
 - whose public interest prevails?

Pressure Points (3)

Market Development

- Market development vs HKEx development
 - A market development initiative may not have a good business case (e.g. dematerialization, fees review)

- Public interest vs HKEx interest
 - Balance of public vs shareholder's interest
 - Public interest shall prevail
 - However, definition of public interest is ambiguous



Role of Government

Government's involvement in HKEx Board

- ❖ FS may appoint no more than 8 persons to be members of HKEx Board
 - Moral hazard / Conflict of interest
 - Duty to the government vs Duty to the shareholders



Thank You