Regulating an Integrated Demutualized Exchange

The Hong Kong Experience*

Andrew Sheng
Chairman
Securities and Futures Commission
Hong Kong

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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
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