Market infrastructure and trading

With global regulatory reforms being set in motion in the aftermath of the financial crisis, we have been reviewing our market standards and raising them as appropriate to align with evolving international benchmarks. In doing so, we believe that we are helping to sustain the long-term growth of Hong Kong markets.

Planning OTC derivatives oversight

Reforming and regulating the OTC derivatives markets is a commitment of the Group of Twenty (G-20) leaders. To that end, we have been working with the HKMA and the Government to develop a regulatory regime for the OTC derivatives market in Hong Kong.

The regime will have to be on a par with international standards, while taking into account features and characteristics of the local markets. Market feedback we sought through public consultation conducted in October 2011 has been helpful in finalising the regime proposals.

Meanwhile, we also participated in international initiatives led by global standard setters (refer to Regulatory Collaboration on pages 45-47 for details). This allows us to keep abreast of reforms in other major markets and ensure that our concerns are considered.

Letting in applicable ATS operators

In April 2011, we granted automated trading service (ATS) authorization to the Hong Kong Mercantile Exchange and LCH. Clearnet Ltd to operate a commodity futures market locally and to provide the related clearing and settlement services. We also approved six other Part III ATS[1] applications from overseas exchanges, bringing the total number of authorized Part III ATSs to 25 as at end-March 2012. Meanwhile, the number of Part V ATSs operated by licensed corporations (including 15 dark pools) climbed to 19 during the year.

Shedding more light on alternative trading and technology-driven trading activities

To increase the post-trade transparency of Hong Kong-listed securities executed in dark pools, SEHK introduced on 1 February 2011 a voluntary flagging requirement. When participants report trades to SEHK, they are required to flag trades executed in dark pools by labelling them as "ALP."

With this information, we have been able to monitor more closely the development of dark pools in Hong Kong. From February 2011 to February 2012, ALP trades accounted for about 1.5% of the total turnover on the Hong Kong securities market.

To stay abreast of issues arising from ATSs and technology-driven trading activities, we continued to participate in the work of the IOSCO's Standing Committee on Secondary Markets (refer to Regulatory Collaboration on pages 45-47 for details). The committee has published principles for dark liquidity in May 2011 and made public a report entitled "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency" in October 2011.

While making reference to the IOSCO principles, we continued to take into account local developments to formulate our regulatory policy on technology-driven trading activities. We are drafting a set of guidelines on electronic trading, which will be the subject of a public consultation later in 2012.

[1] As a general principle under the SFC's *Guidelines for the Regulation of Automated Trading Services*, ATS providers who also perform traditional dealer functions (eg, agency broking, principal trading, market making, holding of clients' securities or funds, and securities borrowing and lending) should submit applications under Part V of the SFO to be licensed for all relevant regulated activities, including ATS. Entities who provide ATS solely should seek authorization under Part III of the SFO.

Reviewing central counterparties' risk control

Central counterparties are of systemic importance to financial markets. We worked closely with HKEx to review the risk management measures of its clearing houses. Based on the review, HKEx proposed reform measures to enhance the overall soundness of the central counterparties in July 2011. Following a public consultation, the implementation of measures was announced in March 2012. We believe that the measures to be implemented will further strengthen Hong Kong's financial system so that current and future challenges are met, particularly in light of continued market growth.

Enhancing transparency of short positions

We held extensive discussions with market participants during the consultation on the proposed Securities and Futures (Short Position Reporting) Rules concluded in February 2012. Subject to the legislative process, the rules will take effect on 18 June 2012.

Under the proposed rules, net short positions that reach the reporting threshold as at the close of the last trading day of each week are required to be reported to the SFC. This information will allow us to monitor the market more effectively, particularly, in helping detect significant build-up of short positions.

Aggregated short positions of each stock will be published by the SFC on an anonymous basis to offer the market more transparency regarding short selling activities.

Enabling launch of listed renminbi securities

We formed a working group with the HKMA and HKEx to enable in April 2011 the listing, trading, clearing and settlement on SEHK of the first renminbi-denominated security – a real estate investment trust (REIT). Prior to the initial public offering, a series of tests were arranged for SEHK participants to verify their operational readiness in conducting renminbi securities business.

To facilitate listing and trading of renminbi-denominated securities on SEHK, we approved HKEx's proposal to introduce the Dual-Tranche-Dual-Counter (DTDC) model and the Renminbi Equity Trading Support Facility (TSF).

The DTDC model enables issuers to raise funds and have their securities traded on SEHK in two currencies ie, HK dollars and renminbi. For investors, the TSF available as a back-up facility provides extra flexibility for them to trade listed renminbi equities in HK dollars.

Approving futures and options contracts

We approved HKEx's proposal to launch futures contracts related to the HSI Volatility Index. Since such an index is a benchmark of volatility of the Hong Kong market, a futures contract launched on 20 February 2012 provides an additional tool for investors to diversify their portfolio and to hedge against volatility exposure to the stock market. In February 2012, we approved yet another proposal of HKEx to launch locally stock index futures contracts of benchmark equity indices in Brazil, Russia, India and South Africa.