LAURA CHA

22 Regulatory Framework after the Merger of the Exchanges

Hong Kong Securities Institute Seminar
21 October 1999

Around October each year, the Securities and Futures Commission (SFC) undertakes to review our corporate plans in the context of the budgetary exercise for the next financial year. Last year, with lessons learned from the Asian financial crisis, the Commission took a critical look at the fundamental structure of our market and determined that major reform in several areas would be required in order to keep the Hong Kong market updated in the rapidly changing globalized markets. We were pleased to have the full support and encouragement of the Government, without which it would not be possible for us to put the proposed reforms on our work program.

In March this year, the financial market reform programs were announced by the Financial Secretary in his Budget Speech. I would like to take this occasion to give you a progress report on the three major reform projects of which the SFC has responsibility: first, the demutualization and merger of the Stock Exchange of Hong Kong (SEHK), the Hong Kong Futures Exchange (HKFE) and the three Clearing Houses; second, the Steering Committee on the Enhancement of Financial Infrastructure (SCEFI); and third, the consolidation of all securities-related legislation in the form of the Securities and Futures Composite Bill.[1]

The reasons and the urgent need for reforming the Hong Kong market have been well articulated in both the Budget Speech and the policy papers[2] issued at the time, and have since been explained by both the Government and the SFC on many occasions. No doubt you are all familiar with them and I will not repeat them here.

Let me now deal with each of the reform projects in turn.

eFrastructure

First, the enhancement of Hong Kong's financial infrastructure: our Chairman, Andrew Sheng, who chairs the Steering Committee, has already reported on the preliminary findings by this Committee last week. I will only summarize the key features of what Andrew called "efrastructure", the components of which include: single clearing arrangement, straight-through processing, scripless securities markets; and open, robust, and scalable technology structure. Each of these components has its own set of building blocks which are inter-related and will build on one another.

It is envisioned that the upgrade and enhancement of our financial infrastructure will enable us to accomplish our strategic objective of embracing state-of-the-art technology in order for Hong Kong to remain in the premier league of world financial centers, by enhancing the competitiveness of our market in terms of risk mitigation, efficiency improvement, and cost reduction.

To arrive at our destination, the Steering Committee has proposed the following initiatives to be completed within a 2-year time frame:

1. To implement consolidated account reporting;
2. To build a securities and derivatives community network (FinNet for securities clearing first);
3. To implement appropriate risk management;
4. To implement electronic filing for intermediaries on FinNet;
5. To upgrade securities clearing to open architecture;
6. To achieve single clearing arrangement;
7. To enable straight-through processing;
8. To consolidate derivatives clearing onto a single platform; and
9. To realize scripless securities market.

Many of these initiatives will need the collective efforts of the SFC and the new Exchange. With the support of the Government, we believe that our strategic objective is achievable in two to three years.

The Composite Bill

The second major reform that the SFC has been undertaking is the preparation of the Composite Securities and Futures Bill, which was started some years ago. The contents of the proposed Composite Bill would be the subject of a separate speech alone. In the interest of time, I would only outline the key features and leave the discussion for another day.

Eventually, the key features of the Composite Bill are:

1. Clarification of regulatory objectives of SFC;
2. Strengthened supervisory and investigative powers;
3. Civil fine based enforcement;
4. Market Misconduct Tribunal;
5. A streamlined licensing regime for market intermediaries and advisers;
6. New regulation on electronic trading; and
7. Expanded accountability and checks and balances for SFC decisions.

With regard to the clarification of our regulatory objectives, we realize that clear objectives constitute vision and purpose of our regulatory regime. We will therefore establish benchmarks for our performance; set the principles by which we exercise our powers; increase transparency and accountability to the public. At the same time, we will continue to maintain and promote fair, efficient, transparent and orderly securities, futures and related financial markets; promote public confidence in and understanding of the financial system, and secure appropriate degree of protection of investors in securities. In furtherance of our functions, we will continue our efforts in minimizing crime and misconduct and reduce systemic risks in the securities, futures and other related financial markets. Finally, in carrying out our functions, we will assist the Government in maintaining stability and integrity of the monetary and financial systems in Hong Kong.

It is currently intended that the draft Bill will be put to Legislative Council (LegCo) in December of this year and the Financial Affairs Panel has already formed a Sub-Committee to study our proposals.

Demutualization and Merger of the Exchanges and Clearing Houses

Now, let me turn to the focus of my subject today: the merger of the Exchanges and Clearing Houses. As you will all be aware, the demutualization and integration of Hong Kong's market operators i.e., the SEHK, HKFE and their respective clearing houses has recently been overwhelmingly endorsed by the members of the two Exchanges. A new holding company, Hong Kong Exchanges and Clearing Limited (HKEC)*, will be established and is expected to be listed on the Stock Exchange during the course of next year. I would like to explain the roles facing the SFC as regulator during and after the implementation of the merger.

Hong Kong is bringing its Exchanges and Clearing Houses up to date not a moment too soon. Over the last seven months since the Financial Secretary announced the merger of our market operators, the pace of change in the securities industry worldwide has been frenetic - even the New York Stock Exchange, the world's largest exchange, with over 1,300 members, has now bowed to competitive pressures and is moving rapidly towards demutualization. Surely it

* Upon the merger of the exchanges and clearing houses, Hong Kong Exchanges and Clearing Limited adopted the acronym HKEx.

would now be impossible to deny that the securities community has reached an implicit consensus that demutualization maximises efficiency incentives and is critical to the survival of international exchanges.

The SFC's Role in the Merger

Against the background of the challenges facing Hong Kong's market operators, and our proposals to address these by restructuring the market, let me describe the SFC's role in the merger/and the post-merger environment.

As the securities and futures market regulator, the SFC has been closely involved in the conception and implementation of this major reform. By assisting the Government in guiding the demutualization of the Exchanges and the proposed listing of HKEC, the SFC has ensured that regulatory concerns are addressed as the market restructure takes place. The SFC's overriding concerns lie in ensuring that the existing market structure continues to operate effectively during the period of transition, that the procedures to implement reform are fair and transparent and conducted in accordance with all applicable legislative and regulatory requirements and accepted principles of good corporate practice, and that the new market structure fully reflects the important public role to be performed by HKEC.

The SFC has also been closely involved with the Financial Services Bureau in the drafting of the Enabling Legislation which is required to implement some aspects of the merger. The draft Exchanges and Clearing Houses (Merger) Bill will make only those changes to the existing legislative framework as are required to provide for the new holding company structure to come into being and to introduce a regulatory framework to govern the new merged group. Among other things, the Merger Bill will introduce new legal personalities, such as "exchange participant" (in place of exchange "member" or "shareholder") and "recognised exchange holding company" and provide for their regulation; it will also convert the Stock Exchange's

Clearing House - HKSCC - from a company limited by guarantee to a company limited by shares. It will provide controls on the size of shareholdings in the holding company and on the transfer of shares in the subsidiaries. The drafting of the Merger Bill continues and is expected to be completed by the end of October and introduced into LegCo by the beginning of November. It is currently hoped that the Bill will be enacted by the end of January 2000.

Rationalization of the Regulatory Function in the Post-merger Environment

At the same time as being actively involved in the broad thrust of the merger transaction and in the drafting of the Enabling Legislation, the SFC has undertaken a review of the regulatory functions which are presently shared between the Exchanges and the SFC. The reforms to be implemented in the post-merger environment have been designed with a view to rationalizing the division of those functions, removing potential conflicts which are inherent in self-regulation, improving efficiency and reducing unnecessary regulatory burdens on market participants. There is presently an element of duplication in the performance of the regulatory function in Hong Kong which is undesirable and increases costs for issuers, investors and other market participants.

The review of regulatory functions focused on four main areas, namely market surveillance, intermediaries supervision, compensation arrangements and listing and corporate finance. A review of current regulatory functions shared with the Clearing Houses has also been undertaken but forms part of the initiative and separate timetable under the Steering Committee on the Enhancement of Financial Infrastructure, which I have already described. Separately, a revamp of the current compensation arrangement is being studied with the new HKEC and will take some time for an integrated proposal to be developed and implemented. Let me now turn briefly to the rationalization proposals concerning market surveillance, intermediaries supervision and listing/ corporate finance matters.

Market Surveillance

In relation to Market Surveillance within the Exchanges, it was decided that the division of functions would remain substantially as at present, albeit with clearer delineation and refinement of respective responsibilities in order to reduce current areas of overlap and inefficiency. The separation of functions between HKEC and the SFC would be formalized by the introduction of clear written procedures.

As a commercial organisation, HKEC's surveillance functions will be more business-oriented. Thus, its market surveillance unit will focus on trading operations and risk management, which include: (a) enforcement of trading and clearing rules and detection of trading malpractices by users (liaising with the SFC as necessary in relation to those malpractices which may involve statutory offences); (b) maintenance of market transparency by monitoring price and turnover movements on a real time basis and requiring prompt disclosure of price sensitive information; (c) assisting in the risk management process by monitoring exceptional concentrations in positions and unusual price fluctuations; (d) interaction with market participants, including handling of disputes in relation to trading matters; and (e) cross-market surveillance of HKEC's users.

With our wider statutory powers, the SFC, as the oversight regulator, will be primarily responsible for detecting market malpractices with statutory implications. The SFC's market surveillance activities would therefore include: (a) scrutinizing market activities to detect potential breaches of laws relating to the securities and futures market; (b) conducting investigations of possible statutory offences that fall within its jurisdiction, including those commenced on referrals from HKEC, other agencies and complaints from the public; and (c) overseeing the surveillance actions undertaken by HKEC and performing cross-market surveillance of activities between HKEC markets and Non-HKEC markets.

Intermediaries Supervision

In relation to Intermediaries Supervision, the functions currently performed by the Exchanges in the prudential regulation of their members would be moved to the SFC. However, HKEC would continue to monitor particular aspects of the business of intermediaries so that it may assess and manage the risks inherent in the operations of its subsidiary business units.

At present, the Exchanges are primarily responsible for the routine inspection of their members' businesses, for monitoring their compliance with trading and conduct rules and the liquid capital requirements, and for ensuring that their members have in place proper systems of management and control. The SFC, however, retains a shared responsibility for all of these matters and is often required to act in response to regulatory concerns, particularly where the necessary response extends beyond the scope of the Exchanges' authority. Transferring the primary responsibility for those matters to the SFC will remove duplication and overlap and ensure that a comprehensive response to regulatory issues can be made by the primary regulator.

This transfer of functions should also remove potential conflicts of interest which may arise in future between the Exchanges and those of their users which may decide to develop alternative trading systems which compete with those of the Exchanges.

Listing/Corporate Finance

In relation to Listing and Corporate Finance, the division of functions would remain substantially as at present, albeit with improvements in efficiency within the Stock Exchange's Listing Division and in the co-ordination of functions undertaken by both the SFC and the Stock

Exchange. This would necessarily involve a re-examination of the allocation of resources by both the Exchange's Listing Division and the SFC's Corporate Finance Division and an examination of our functions and work processes. The SFC contemplates entering into a new Memorandum of Understanding with HKEC which would clarify the standards to be met by the Stock Exchange in performing its functions in this area and provide for greater interaction between the two bodies.

Furthermore, and in order to remove the conflict of interest which would arise if the Stock Exchange were to supervise its own holding company, the Enabling Legislation will provide that the SFC will be responsible for all matters regarding HKEC which would, in the case of any other listed company, be dealt with by the Listing Division. Provisions will be included in the Merger Bill to provide for new listing rules allowing the SFC to "step into the shoes of" the Listing Division in relation to HKEC's own listing and its continuing compliance with the Stock Exchange's listing rules. The SFC may also need to assume the role of front line regulator more broadly in relation to other listed companies or exchange participants in all cases where it considers that the business interests of HKEC as a corporate entity may conflict with its subsidiaries' responsibilities as market regulators. This is likely to be the case, for example, whenever HKEC and any other Hong Kong listed company or exchange participant are competing for business and the resulting transactions require the performance of a regulatory function ordinarily performed by one of the HKEC group companies, such as a disclosure of information to the public under the listing rules requiring the involvement of the Listing Division of the Stock Exchange.

Staffing Needs

Many people have asked: what does regulatory rationalization mean to the organizations concerned? More importantly, what is the impact of rationalization on the staff of the two Exchanges and Clearing Houses?

I am pleased to report that over the last two months, we have worked closely with the management of the SEHK, HKFE and HKSCC to design a transition program which will both capture the skills and experience of the current staff of these three organizations and ensure the continuous smooth operation of the marketplace. We are also keen to ensure that regulatory functions would continue to be performed properly so that in the course of the transfer of function there will not be any gap or overlap.

With this in mind, the SFC has estimated that we would need to recruit approximately 50 new staff in the course of the next 12 months to carry out our expanded responsibilities. The new staff will be recruited in stages, with the first batch of 15 or so to commence shortly so that they could be in post by January 2000. We are eager to retain the experience of the existing staff of SEHK and HKFE and will therefore direct our efforts in recruiting our first batch of new staff solely from these three organizations. We have also agreed with the management of the Exchange that a combination of recruits as well as secondment will be put in place to facilitate the expedient transfer of functions as well as the smooth operation of the HKEC.

The positions and job specifications for the new posts will be provided to the Exchanges in the next week or so.

Evolution of the Regulatory Role into the Next Millennium

Considerable challenges are facing Hong Kong's securities and futures markets. The three reform programs I have described today are designed to meet such challenges head on.

In the coming year, the SFC will devote much resources in completing and implementing these three major market reforms. We recognize that much is on our plate and that we rely on the support of the Government to make it possible for us to complete our tasks. In this regard, I am pleased that the unity of purpose and the collective efforts of the Government, regulator and market participants in the last year have demonstrated that together we can indeed make our market better in the face of competition.

A modern and competitive market both requires and benefits from the presence of a focused, capable and respected regulator charged with maintaining market integrity and protecting investors. In order to discharge our statutory responsibilities, the SFC must keep abreast of market developments in Hong Kong and overseas; we must increasingly co-ordinate with regulators in other jurisdictions in order to facilitate and safeguard cross-border investment activities; and most importantly, we must be forward-looking and facilitative of change. Hong Kong has accepted the need to re-engineer its market institutions, infrastructure and securities regulations in order to participate and compete effectively in the increasingly complex and sophisticated global securities and futures markets. It must also ensure that it continues to have, and is seen to have, a world class regulator.

With the support of Government and the market the SFC is eager to develop our activities and skills base as necessary to ensure that we continue to provide Hong Kong with a world class regulator which will be a partner to our world class markets.

Postscript

The demutualisation of SEHK and HKFE, and the merger of these two exchanges and their associated clearing houses into a single holding company, HKEx, was completed on 6 March 2000. HKEx was listed on 27 June 2000. The Securities and Futures Ordinance was enacted in the Legislative Council on 13 March 2002.

Endnotes

1 Financial Services Bureau (1999), "Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre", July (Hong Kong Special Administrative Region Government).
Visit http://www.info.gov.hk/fsb/reinforc/index.htm

Report on the Enhancement of the Financial Infrastructure in Hong Kong: "An eFrastructure for a Leading eEconomy", prepared by the Steering Committee on the Enhancement of the Financial Infrastructure, September 1999.
See Publications - Others at http://www.hksfc.org.hk

For Consultation Papers on the Securities and Futures Bill, visit http://www.info.gov.hk/fsb/consult/index.htm and http://www.info.gov.hk/fsb/bill/index.htm

2 A Policy Paper on Securities and Futures Market Reform, March 1999, Government of the Hong Kong Special Administrative Region.
Visit http://www.info.gov.hk/fsb/security/sec_1.doc