Introduction

Good morning ladies and gentlemen. I will like to thank the TradeTech organisers for inviting me to speak at this event again. Although the last few years have been challenging ones for a lot of us, the organisers have stoically kept this annual event going and it gives me great pleasure to be here today at a time when world economies are back on track and promising times lie ahead.

The topic that I have been asked to speak on today is: What do regulators want from the trading marketplace? What regulators want may not always be consistent with what the market wants and vice versa. But an effective regulator is able to achieve a balance that, while not making everyone happy on day one, but will achieve long term results which it will be applauded for on hindsight.

There are many different areas and many different perspectives to a discussion of ‘what regulators want’. I intend to discuss it in the context of competition in the market, particularly the concerns that arise from fragmentation in the market. Next, I will share with you my thoughts on where Hong Kong is at vis-à-vis the regulatory reforms in the US and Europe.

Competition in the market place

It is interesting to see where competition has taken the markets globally and where the competitive forces are continuing to drive the markets. There is increasing competition in the secondary trading business of exchanges. Essentially, exchanges face two forms of competition. Firstly, it is the competition from alternative trading venues. Secondly, it is the competition they encounter at a more macro level from merged exchanges.

Competition from alternative trading venues

Exchanges in the US and Europe are already facing stiff competition from alternative trading venues and in the not too distant future, the same will also be happening in Australia.

Not all exchanges enjoy a monopoly status, some do and some don’t. The monopoly status is conferred by the law of the jurisdiction where the exchange operates and as is the case with any piece of legislation, the law could be amended. Therefore, if the relevant law which confers the monopoly status is amended and the monopoly privilege is removed, it is only a matter of time before competition sets in.
This is evident in the US and Europe. In 1975, the Congress in the US made changes to the Exchange Act which essentially removed the monopoly status of exchanges in the US. This allowed competition amongst different trading venues and de-centralized equity trading from the exchanges in the US. This resulted in a significant migration of trading volume away from the exchanges. For example in 1987, the NYSE executed almost 74% of NYSE listed stocks, in 1995, the volume was down to 70.22 % and it is now below 20%.

Across the Atlantic, a similar change to laws in Europe removing the monopoly status of exchanges came into effect in late 2007. There is a lot of published data which show that trading volume has migrated from exchanges to alternative trading venues. But the European model is a relatively more centralized market, e.g. about 60% of the stocks listed on the LSE are currently still traded on the LSE.

Australia is a little different in that the laws did not specifically confer a monopoly status on ASX. However, competition was not welcomed, thus operators of alternative trading venues did not actively seek opportunities to set up operations in Australia. This changed on 31 March 2010. On this date, the Australian Government publicly announced its support for competition with ASX. In the same announcement, the Australian Government also announced its in-principle approval for Chi-X to operate in Australia. That was a year ago.

A lot has happened in Australia in the last one year. In preparation for market operators other than ASX to operate in Australia, the regulators have put together a framework of rules and I understand that the new rules are in the process of being rolled out and Chi-X is expected to be up and running in October or November this year.

One of the tools that some market players use to understand the trend in market fragmentation is the Fidessa Fragmentation Index (FFI). The FFI measures the average number of venues you should visit in order to achieve best execution when completing an order. In both Hong Kong and Australia, the FFI is currently 1, i.e. the stocks are still traded at one venue (which is the original market where it is listed). In Europe, the FFI of FTSE 100 stocks is 2.47 while in the US, the FFI of Dow Jones Index stocks is 5.13. In these two regions, the stocks have become fragmented to the extent that they no longer “belong” to the original market.

As you can see, HKEx remains the sole exchange operator in Hong Kong. This monopoly status that HKEx enjoys is entrenched in the law (in section 19 of the Securities and Futures Ordinance) and this will remain to be the case until such time that section 19 is amended. So, we ask ourselves, if everyone is doing it (i.e. allowing competition in the market), why is Hong Kong not doing the same. I am unable to offer an answer to this question as this is largely a matter of policy which falls within the purview of the Government. But I can certainly share with you my thoughts on it.

Arguably, allowing other market operators to compete with exchanges does deliver some benefits to investors such as more competitive pricing, more innovative services and improvement in quality of services. There is value in these arguments and I can certainly see why the more developed markets have moved away from a centralized market structure towards a more fragmented market.
But I am mindful that allowing competition in the market invariably results in a fragmented market. Regulators in the US and Europe continue to grapple with issues associated with market fragmentation. Market fragmentation issues will exist as long as a multiple-market operator structure continues to exist. So what are these issues?

(a) A possible degradation of the price discovery process and market efficiency: This manifests itself in various ways.

- As orders are spread among a number of different trading venues, the market depth of each venue is reduced and execution of a large order in any one of the trading venues is more likely to produce an adverse price movement. Also, the reduction of order book depth may widen the bid-ask spread of the market.

- When trading activities are conducted on different platforms, pre- and post-trade information are not consolidated and displayed from one source. This reduces the overall market transparency. A consolidated price tape may help, but not all investors can or want to pay for price feeds from individual platforms directly. Hence, traders (usually sophisticated or institutional investors) who can afford to pay for the price feeds will receive the information earlier than others who rely on the consolidated price tape. The trade-off for these traders, of course, is that the fee they pay for price feeds will result in an increase in their overall transaction costs.

- Strict price time priority of order matching cannot be guaranteed in a multiple-market structure. Orders with an inferior price may get filled in one trading venue while orders with a better price may still be waiting for execution on another venue. This may result in a less reliable and less stable price discovery process.

(b) New forms of trading abuses: There is room in a multiple-market structure for new forms of trading abuses to emerge. Regulators will have to be more vigilant and put in place appropriate market surveillance practices and systems. If the exchange is the front line regulator undertaking the market surveillance responsibility, a conflict of interest issue may arise when there are multiple trading venues competing with it. It may no longer be appropriate for the exchange to perform surveillance functions for the market as a whole. Regulators are expected to take up the function and ensure that market surveillance can be performed effectively under the fragmented market structure. This occurred in Australia as a prelude to Chi-X’s commencement of operations. The surveillance functions which originally resided with the ASX were moved to ASIC.

(c) Fair access to clearing and settlement facilities: Exchanges in Asia usually own the only clearing and settlement facilities in the market. Unlike trading platforms, the set-up costs for clearing and settlement facilities are high and therefore we have not seen sufficient competition in the clearing and settlement space to drive the costs down. It is essential to have fair access to clearing and settlement facilities to enable a level playing field between exchanges and alternative trading venues.

In the US and Europe where there are multiple market operators, to overcome the market fragmentation issues (or to enhance profit opportunities), the markets have evolved to a structure which is less centralized at the platform level but more centralized at the technology/network level. Well-resourced or sophisticated participants have the ability to
access all relevant information across diverse platforms through the widespread adoption of FIX, smart order routing and integrated data feeds. As a regulator, our focus is on whether diverse platforms are accessible in a non-discriminative manner either directly or indirectly and whether multiple data sources can be reintegrated at the user level at a reasonable cost. In other words, market fragmentation should not result in excessive costs for investors to search different venues for best execution and cause concerns about fairness.

**Competition from merged exchanges**

Other than competition from alternative trading venues, stand alone exchanges are facing intense competition from merged exchanges. Are merged exchanges more competitive? The industrial logic for merging exchanges are that the merged entities enjoy benefits (which stand alone exchanges do not enjoy) such as economies of scale (in information technology, clearing and market operations), rationalisation of costs, larger liquidity pools and more varied product offerings/listings.

Merged exchanges can also benefit from the profile of their merger partners. For example, a traditionally non-technology exchange may attract listings from technology companies if its merger partner has a very strong technology sector.

The recent wave of consolidation has been well covered and discussed in the media and I will not repeat them here. Instead, I will elaborate on one of them – Euronext, which went on an acquisition spree as far back as 2000.

- Euronext was formed from a merger of the Amsterdam Stock Exchange, Brussels Stock Exchange, and Paris Bourse in September 2000. The merger was a natural consequence of the harmonisation of the European Union financial markets.
- It acquired LIFFE in December 2001 and went on to merge with the Portuguese Stock Exchange a year later.
- Some five years later, the NYSE Group and Deutsche Borse made competing bids to acquire Euronext. Deutsche Borse dropped out of the bidding leaving the NYSE Group as the victor and on 4 April 2007 NYSE Euronext was formed.
- Just this February, we have seen Deutsche Borse and NYSE Euronext commenced merger negotiations.

I would like to clarify that NYSE Euronext has been quoted as an example here purely for illustrative purposes to better demonstrate the points that I am making.

The arguments for merging exchanges may be theoretically sound. But are they supported by evidence? Here are some statistics pre- and post-merger of NYSE Euronext in April 2007. Total market capitalisation of listed companies in the US and Europe witnessed a decline of 15% as at end of 2010 from pre-merger position in 2006. In the same period, the total market capitalisation of TSX Toronto has risen by 28%, Hong Kong 58% and Shanghai a whopping 196%. Average daily turnover for equity trading for NYSE Euronext in the two-year period 2008-2010 increased by 37% from the 2004-2006 level, compared with a 53% increase for TSX Toronto, 166% for Hong Kong and 826% for Shanghai. Finally, as for average IPO funds raised, there was a decline of 56% for NYSE Euronext, when Toronto dropped 38%,
Hong Kong 25% and Shanghai saw an increase of 64%. The statistics show that the NYSE Euronext merger did not grow the two existing liquidity pools further and did not enlarge the investor base to outperform other exchanges. Turnover growth was less significant than other exchanges. Market capitalisation and fund raising activities also did not increase as expected. However, I am not discounting the possibility that there may be other factors which affected the performance of the markets at that time.

Also, it is worth highlighting that mergers of exchanges may be more than just a matter of combining businesses and it may be idealistic to assume that life would go on in the same way it did pre-merger. The different regulatory, operational and management approach governing each entity may result in challenges pulling in different directions. These may or may not be overcome depending on how they are managed.

I wrap up this discussion with the observation that there are arguments for and against the consolidation of exchanges. Much depends on the history and unique characteristics of each market, and ultimately it depends on the price, the strategic and management fit of the entire exercise. What is certain is that competition in the exchange business is getting more intense and it is wise for exchanges (regardless of whether they enjoy a monopoly status) to step up efforts to improve the quality of their services and ensure competitiveness of pricing.

As a market regulator, the SFC welcomes competition as long as investors’ interest is not compromised and the market continues to be fair, efficient and has its integrity intact. When competitive forces enter the fray to challenge the traditional business model of exchanges, new regulatory issues will definitely emerge. It is important for regulators and market participants to work together to identify appropriate solutions to such issues and provide a sound and stable regulatory environment to ensure business sustainability and to enable further developments.

Regulatory changes in the US and Europe

Interestingly, as exchanges worldwide are working hard to remain competitive, regulators worldwide are working equally hard to roll out regulations that are engineered to preserve the quality of the market place.

Post-financial crisis, regulators in the US and Europe have overhauled or looking to overhaul a large part of their regulations. As we know, the US and Europe were the worst hit during the crisis as compared to Asia-Pacific countries which have emerged relatively unscathed. It is therefore not unexpected that regulators in the US and Europe are tightening up their regulations. The unfortunate May 6 incident in the US last year added further impetus to change.

I will briefly mention some of the more relevant regulatory changes and consider whether and if so, to what extent regulators in Asia (more particularly Hong Kong) should look to the US and Europe for guidance.

Conventional wisdom would suggest that Asian markets should look to advanced markets like the US and Europe where there are more sophisticated participants and innovative products.
While I do not dispute the conventional thinking, I think it really comes down to the issues that are being considered. Some of the proposals are in relation to issues that are peculiar to the US or Europe markets because of their market structures. While it is advisable for Asian regulators to keep abreast with the developments in the US and Europe, they may be of limited relevance if the proposals cater for a market structure (i.e. a fragmented market) which is different from the market structure we have in place here.

Moreover, some of the recent proposals appear to be efforts by the SEC to rein in or to tighten up regulations of market practices in the US. Over the years, as the US market matures, mechanisms like flash orders, IOIs and naked or unfiltered access have been introduced. These have inevitably resulted in a two-tier market and to an extent have compromised the investor protection angle. The US regulators are now considering prohibiting some of these practices or to introduce more stringent regulatory requirements in relation to some trading practices.

In the course of developing our market further, we will consider adopting or allowing more sophisticated trading practices and when we do, we have the benefit of learning from the US or Europe experience and hopefully we can strike a middle ground right from the outset instead of starting off liberally and having to pull back eventually. I would like to take the remaining time to discuss some of the issues that have been receiving a lot of regulatory attention in the US and Europe and share my views with you.

Direct Market Access (DMA)

In November 2010, the SEC rolled out rules imposing pre-trade risk management controls for brokers offering DMA. The controls essentially require pre-trade filtering by the brokers’ system. These rules have the effect of banning naked or unfiltered access.

In Hong Kong, we do not have specific regulations on the use of DMA. It is however an area that we are closely monitoring. We have been told by some firms that about 20% of their trading in the Hong Kong stock market is associated with DMA activities. I anticipate the industry’s concerns with pre-trade filters are that they might result in increased latency, increased trading costs and an overall reduction in liquidity and trading volume.

However, these concerns ought to be weighed against the benefits of having pre-trade filters, including reducing risks to brokers and the market, enhancing market integrity and investor protection.

In August 2010, IOSCO published principles for Direct Electronic Access to Markets designed to guide intermediaries, market operators and regulators in several areas, namely, pre-conditions for DMA, information flow and adequate systems and controls. The SFC is considering whether additional requirements or guidelines should be introduced at both the exchange and broker levels to ensure that the use of DMA will not result in undesirable consequences and increased risks to the market. We will talk to market participants in due course to seek their input.

Dark Pools

In Asia, dark pools and other alternative trading venues are still at an infancy stage. While they are already making their presence felt in the Asian markets, it is hardly close to the
extent of the domination of their counterparts in the US and Europe. One of the key reasons is that the exchanges in Asia have monopoly status (actual or de facto) and alternative trading venues cannot compete with the exchanges on a level playing field. In Hong Kong, we have seen the number of alternative trading venues, mainly brokers’ internal crossing systems, increased from just a handful several years ago to 15 currently.

At present, dark pools only account for a very small portion of the Hong Kong market turnover. As a result, most of the issues associated with dark pools which regulators in the US and Europe are grappling with such as the lack of transparency, impaired price discovery and the lack of fairness are not posing any real concerns to us at this juncture. However, it is important for us to keep a close eye on the development of alternative trading venues in Hong Kong and when the situation warrants, we would consider providing appropriate regulatory responses.

In order to enhance the monitoring of activities of alternative trading venues in Hong Kong, starting from 1 February 2011, trades concluded on brokers’ internal crossing systems were required to be flagged as “ALP” (i.e. Alternative Liquidity Pool) when the brokers report them to the exchange. This information is made available by the exchange to the SFC but not to the public. Prior to this new requirement, such trades were reported to the exchange together with other cross trades. This made it difficult for us to monitor the development of alternative trading venues in Hong Kong. With the implementation of the new flagging requirement, we now obtain information about activities of alternative trading venues on a daily basis. The volume of trades executed on dark pools in Hong Kong is fairly small – on average, 1.1% of total market value in February 2011. If this increases significantly, we may need to review our regulatory approach to alternative trading venues.

**High Frequency Trading (HFT)**

HFT is not a new phenomenon but it achieved new notoriety after the May 6 incident in the US. Despite the official joint-findings by the SEC and the CFTC that HFT activities did not cause the incident, HFT has somehow remained as the scapegoat.

Investors and the industry (other than HFT firms of course) have proposed that HFT be more tightly regulated. I am aware that regulators in the US and Europe are taking steps to establish whether new HFT-specific regulations are indeed required. As far as I know, the jury is still out on this.

My view is that HFT is more a technology rather than a strategy and regulations should be technology-neutral. By this I mean whether a technology is a Generation X technology or a Generation Y technology, it should be subject to the same rules regarding trading obligations and trading abuses. It is not sensible to customise regulations to cater for a particular technology.

Nonetheless, I do accept that the very nature of HFT i.e. being ultra-fast, has the potential to bring risks and fragility to the market especially during a market dislocation. There are various measures to address this – such as circuit breakers and other technological related mechanisms or the imposition of penalty charges where there is an overly disproportionate order-to-execution ratio.
HFT has not gained much traction in Hong Kong, at least not in the equities market. This is largely due to the frictional cost of trading equities in Hong Kong. The stamp duty of 0.1% of the transacted value payable by the buyer and the seller respectively can easily exceed the wafer-thin profit per HFT trade. Stamp duty is not required to be paid on trades in the US and many of the major markets. Although trades attract stamp duty in the UK, only the buyer is required to pay.

We will continue to monitor the developments in the US and Europe in relation to HFT and if it comes to our attention that there is a gap in our regulations, we will certainly do what is necessary to plug that gap.

MiFID Review in Europe

I will not be discussing the proposed changes to MiFID as Dr Swinburne from the European Parliament will be talking about these later this morning.

I did however make the following observations about some of the proposed changes to MiFID. There are several areas of reform proposed by the European Commission which are fairly similar to the SEC’s regulations, for example, the publication of post-trade transparency information on a consolidated tape, the requirement for dark pools to comply with pre-trade transparency obligations when their trading activity crosses a certain threshold and the requirement for execution venues to produce periodic reports on execution quality.

I am not suggesting that a regulatory convergence of any sort is in the pipeline. But I do think that regulators are guided by the high level principles set by IOSCO in shaping the regulations in their respective markets, thus some similarities will emerge. We may have our individual views driven by the unique circumstances in our domestic markets but the high level concepts do not tend to differ too dramatically between the different markets without good reasons.

The SFC actively participates in international forums and will continue to enhance cross-border cooperation and information-sharing with our peers. We work very closely with our counterparts from the US and Europe and I think there is a lot to be gained from tapping into their experience.

Although like I said, because the market structure in Asia including in Hong Kong is different from the market structure in the US and Europe, the concerns and issues the regulators encounter in the US and Europe are not directly applicable here. Having said that, things are constantly evolving and we cannot exclude the possibility that Hong Kong or any of the Asian markets may be as fragmented as the US or Europe markets in times to come and when that happens, the US and Europe experience becomes directly relevant.

Conclusion

In conclusion I stress again the importance of embracing competition in the trading space. Much is to be gained from healthy competition within a well-regulated environment. On the other hand, competition will bring in new types of market participants and trading behaviours which may challenge the status quo. Regulators need to maintain a regular dialogue with the industry to obtain market intelligence on potential issues. If there are any views and ideas that you will like to bring to my attention, I am happy to hear them.
Before I end, I will like to accord my sincere thanks to the organisers. To all the participants, thank you for your presence and I wish you all a productive and fruitful conference.

Thank you.