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Regulating an Integrated Demutualized Exchange  
The Hong Kong Experience

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# Regulation of HKEx

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Balance profit orientation against need to regulate:

- 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 FLR and listed company

# Ownership of HKEx

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- Only recognized exchange controller 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 FS)
- Financial Secretary can grant exemption (e.g. mergers, alliances)

# Corporate Governance of HKEx

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## Risk Management Committee

- formulate policies on risk management matters relating to the HKEx and its exchanges and clearing houses
- chaired by Chairman of the HKEx
- includes Chairman SFC, CEO of HKMA
- 1 - 3 other members appointed by the Financial Secretary
- 2 other members appointed by the Board of the HKEx
- can be over-ruled by Board of HKEx

# External Regulation of HKEx

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HKEx to:

- ensure orderly and fair markets
- ensure risks exchange, clearing houses are managed prudently
- ensure exchange, 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 exchange

## External Regulation of HKEx (2)

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

# Conflicts of Interest

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## S.14 of Merger Ordinance:

- 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

## Conflicts of Interest (2)

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### S.13 of the Merger Ordinance:

- before listing of HKEx, the SFC had to 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

# Conflicts of Interest (3)

Requirements of S. 13 and S. 14 of the Merger Ordinance are satisfied by :

- 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

# Pre-Listing MOU

- Summarises SFC (HKEC Listing) Framework in relation to listing matters of the HKEx (and other companies with potential conflicts of interests)
- Contains procedures to deal with conflicts of interests:
  - HKEx staff identifies conflicts or potential conflicts
  - Refer conflicts to a Conflict Committee (CC) comprised of senior executives of HKEx
  - CC refer cases to “SFC Representatives”
  - “SFC Representatives” decide whether to accept CC proposal or to intervene by exercising powers under relevant procedures
  - HKEx may appeal to the Commission if it disagrees with decision of the “SFC Representatives”

# Internal Checks and Balances

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

# Regulatory Rationalization

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- Exchanges no longer have role as SRO of exchange participants
- Phase 1: SFC took over administration, enforcement Exchange 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 of HKEx including :

- routine inspection of business
- monitor compliance with conduct rules
- monitor compliance with financial resources rules
- ensure proper internal controls in place
- investigate and discipline intermediaries for misconduct

HKEx retains FLR responsibility of user supervision to :

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

# Market Surveillance

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

- enforcement of trading and clearing rules
- maintenance of market transparency
- assisting the risk management process
- interacting with market participants
- cross-market surveillance of HKEx market users

# Market Surveillance (2)

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SFC primarily responsible for detecting market malpractice with statutory implications:

- monitor market movements to detect breaches of laws administered by the SFC
- conduct investigations of possible statutory offences
- oversee surveillance actions of HKEx
- perform cross-market surveillance between HKEx markets and non-HKEX markets

# Side - Effects

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- 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 Bill
  - much more direct liaison between SFC and industry groups
- Absence SRO means no “peer review” of exchange participants:
  - increased transparency, accountability of SFC (Process Review Panel, SFAT, User Working Groups, Advisory Committee)

# Moot Points

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

# Moot Points (2)

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## FLR Listing function:

- “gatekeeper” vs disclosure and corporate governance regulator
- perception of conflict:
  - direct - controlled by SFC
  - indirect - e.g. offers of ancillary services to “regulatees”
  - roles: profit vs good rules, profit vs. enforcement/litigation

# Moot Points (3)

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## Cross-Border Issues

- If exchange 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?

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# Thank You