



SECURITIES AND
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Chinese University of Hong Kong Conference on HKEx and the Market Structure Revolution

The Impact of Market Structure Changes on Securities Exchanges Regulation

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Outline

- **The global challenges in the regulation of securities exchanges**
- **The structure of Hong Kong's securities market and its challenges**

The global challenges in the regulation of securities exchanges



The structure of a securities market is shaped by

- **Market characteristics**
(e.g. size of the market, level of development, levies)
- **Degree of competition**
(e.g. whether competition is allowed, and to what extent)
- **Technological developments**
(e.g. whether and how new trading technologies are deployed by exchanges and market participants)
- **Regulation**

All these factors are constantly interacting with one another dynamically in determining the evolution of a market



IOSCO (International Organization of Securities Commissions) has set 3 objectives of securities regulation:

a) 3 Objectives

- the protection of investors
- ensuring that markets are fair, efficient and transparent
- the reduction of systemic risk

b) Key principles for secondary markets

- the establishment of exchanges and trading systems is subject to authorization and oversight
- maintaining fair and equitable rules that strike an appropriate balance between the demands of different market participants
- promoting transparency of trading
- detecting and deterring market manipulation and other unfair trading practices
- proper management of large exposures, default risk and market disruption



The main challenge for securities regulators to maintain market quality is to strike a balance between:

- **Market integrity**
 - fairness, orderliness, confidence
- **Market efficiency**
 - price discovery, liquidity, transparency, transaction costs



Two key trends that have fundamentally changed the competitive landscape of the global exchange markets in the past 2 decades

■ Financial deregulation

- permitting competition among exchanges and ATS (Alternative Trading Systems) domestically and cross-border
- leading to a more fragmented market structure

■ Adoption of new technologies

(advances in computer power, communication technologies, programming capability, trading and investment strategies)

- alternative trading venues such as lit and dark pools
- high frequency trading (HFT)
- algorithmic trading
- direct electronic access
- co-location / low latency services
- tick sizes
- fee structures



The global financial crisis of late 2008 and the “Flash Crash” of 6 May 2010 were the two watershed events that have forced policy makers, regulators and market participants to re-assess the policy implications of today’s fragmented and high-tech driven market structure in terms of market integrity, efficiency and stability.



IOSCO Oct 2011 Report on “Regulatory issues raised by the impact of technological changes on market integrity and efficiency”

5 Recommendations:

- 1) Trading venue operators should provide fair, transparent and non-discriminating access to their markets, products and services
- 2) Trading venues should have in place suitable trading control mechanisms (e.g. trading halts, volatility interruptions, limit up / limit down controls etc.) to deal with volatile market conditions
- 3) All order flow of trading participants should be subject to appropriate controls, including automated pre-trade controls
- 4) Regulators should continue to assess the impact on market integrity and efficiency of technological developments and market structure changes, including Algo and HF trading
- 5) Regulators should monitor for novel forms or variations of market abuse that may arise as a result of technological developments

The structure of Hong Kong's securities market and its challenges



Key characteristics of Hong Kong's stock market

- **Hong Kong is the third global financial centre, after London and New York. (However, its overall market size is still relatively small)**
- **The 6th largest stock exchange in the world in terms of market cap (After Japan in Asia)**
- **The top IPO fund raising market in the world for the past 3 years**
- **Hong Kong's stock turnover ranked the fifth in Asia after Japan, Shanghai, Korea, Shenzhen (it is comparable to that of Germany, Toronto)**

Hong Kong – 6th largest stock market in the world

Top 10 Stock Markets in the World, by Market Capitalization

	Market Capitalization (end Feb2012)			Average daily equity turnover (2011)		
	US\$ billion	Worldwide Ranking	Asia Ranking	US\$ billion	Worldwide Ranking	Asia Ranking
NYSE Euronext (US)	12,809.3	1		71.5	1	
NASDAQ OMX	4,372.5	2		50.5	2	
Tokyo	3,602.5	3	1	16.4	3	1
London SE Group	3,592.1	4		11.2	6	
NYSE Euronext (Europe)	2,722.3	5		8.3	7	
Hong Kong	2,675.2	6	2	5.9	11	5
Shanghai	2,618.0	7	3	15.0	4	2
Toronto	2,112.5	8		6.2	10	
Brazil	1,480.8	9		3.7	14	
Deutsche Börse	1,393.4	10		6.8	9	

Remarks:

1. Market capitalization includes common and preferred shares, but excludes investment funds, rights, warrants, convertibles and foreign companies (definition adopted from WFE).
2. Ranking is only for the top 10 markets by market capitalization.
3. London SE Group includes London Stock Exchange and Borsa Italiana.
4. NYSE Euronext (Europe) includes exchanges of Amsterdam, Brussels, Lisbon, and Paris.
5. Ranking excludes National Stock Exchange of India to avoid double counting with Mumbai on market capitalization.

Source: HKEx, WFE, IMF and SFC Research



Competitive landscape

- **The Stock Exchange of Hong Kong (SEHK) is the only stock exchange permitted under the Securities and Futures Ordinance**
- **Alternative trading systems / venues are allowed to operate in Hong Kong as long as they are operated by participants of SEHK, which are subject to the rules of SEHK and obtain permission from the SFC**
 - There are about 19 such broker-operated crossing systems. The majority are dark pools
 - They account for about 2% of the total market turnover
- **Overseas exchanges and alternative trading platforms are allowed to establish electronic connections to Hong Kong once they obtain authorization from the SFC**
 - There are about 20 such ATS (automated trading services) authorized by the SFC, with the majority being overseas financial and commodity futures exchanges



The regulation of HKEx

- **HKEx was established in March 2000 (after the Asian Financial Crisis which started in 1997) by merging the SEHK, HKFE (Hong Kong Futures Exchange) and the 3 clearing houses**
- **HKEx (as a holding company) was listed on SEHK in June 2000**
- **The operations of HKEx are subject to certain statutory requirements**
 - must act in the interest of the public (to ensure that the interest of the public prevails where it conflicts with its interest)
 - key personnels are appointed by the Government
 - Government's appointment of HKEx Chairman
 - SFC's approval of HKEx CEO and COO
 - SFC's approval of SEHK / HKFE CEO
 - Government appoints public interest directors
 - ownership of 5% or more in HKEx requires SFC's approval (after consultation with the Financial Secretary)



HKEx recognizes the need to stay competitive

- HKEx recognizes the increasingly global and competitive market environment it faces. In the HKEx Strategic Plan 2010-2012, it states that there are two major forces of opportunity and competition at play –
 - Opportunities resulting from the further opening of the Mainland market; and
 - More intense competition from exchanges and trading platforms around the world and in the region.

The increasing internationalization of the RMB will intensify these factors

- HKEx recognizes that it needs to change in order to close market structure gaps vis-a-vis other leading exchanges in terms of trading technologies and market features e.g. trading hours, trading spread, execution at market close, broker anonymity and remote participation as all of these are common features of other leading exchanges in the world



Thank You

