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The HKEx's structure and regulation from a corporate finance perspective

HKEx and the Market Structure Revolution
31 March 2012

Evaluating infrastructure by its purpose and agency hazards

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1. What is the purpose of a securities exchange?

Allocate capital, maximizing network effects, discover price and allow hedging.

2. What are the risks of infrastructural design?

The people controlling the decision-making will design infrastructure for their own benefit.



How then measure markets' efficiency?

1. Does the infrastructure meet its purpose?
2. Have governance structures addressed agency risks (not just entry barriers)?
3. Are negative externalities and extraordinary costs included in our assessments?
4. In terms of the above, what are the costs to ultimate savers and borrowers?

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ASSESSING THE HONG KONG EXCHANGES AND CLEARING LTD.

SEHK – some benchmarks

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1. Led the world in IPO activity 2009, 2010, 2011;
2. Imposes structural governance changes on 85% of its listed companies and polices disclosure duties mostly alone.
3. Among the most expensive to trade on, apparently making HFT impractical;
4. Alternative trading services must be exchange members, co-opting competition;
5. Forward looking, perhaps risky alliance with BRICS economies.

IPOs : decreasing competitive advantage?

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1. Quality of regulation: China is closing the gap;
2. Advantages of Hong Kong dollar is decreasing with new RMB regime;
3. Creation of an international board in Shanghai will allow foreign issuers to access Chinese capital;
4. Following heavy industry listings, startups may gravitate to other markets.



Regulation: HKEx polices the market

1. Listing rules adjust the company law rules of Chinese, Cayman and Bermudan companies, among others;
2. HKEx reviews prospectuses and imposes regular reporting requirements;
3. Related party transactions are policed by HKEx; and
4. This is likely financed with trading revenue.



Cost: levies, fees and duties

1. Total costs for a \$1000 trade, roughly 2%;
2. Transaction levy at 0.003% of transaction value, paid by each side
3. Trading fee at 0.005% of transaction value, paid by each side;
4. Trading tariff at HK\$0.50 on every transaction;
5. Transfer fee at \$2.5 per share certificate;
6. Stamp duty at 0.1% of transaction value.

Information: pre- & post- trade transparency is informal



1. The statutory requirements for publishing pre- and post-trade information are very thin;
2. The SFC has issued policies for disclosure for ATS activities, tied to international standards, which leave considerable room for discretion;
3. In practice, ATS providers are exchange participants and subject to exchange transparency requirements;
4. Thus pre- and post-trade transparency in Hong Kong greatly depends on the HKEx matching international best practices.

Alliances: looking to a new world order

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1. China, India, Russia and Brazil are seen as in G-7 by 2021. Jorgenson & Vu (2011).
2. These BRICS economies need capital allocation to new industries, which requires fundamentals trading.
3. Dealing with large, autocratically controlled national champions could lead to better control of future market relationships.

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THREE STRUCTURE ISSUES: HFT, SECURITIES SETTLEMENT AND PATH DEPENDENCE

Conjecture on effects of HFT

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1. Carry positions very short term, leading to low capitalization and fleeing illiquid markets;
2. Conduct more, smaller trades, and use order cancellations as a regular strategy, damaging environment for larger trades;
3. This stimulates flight to block trade friendly dark pools, fragmenting market; and
4. Automated decision-making increases risks of bad reactions, multiplied in effect.



Securities settlement for investors

1. The Hong Kong Securities Clearing Company Limited and the Hong Kong regulators have committed to a dematerialized market;
2. This will allow for elimination of the artificial distinction between registered and beneficial owners and restore shareholder communications;
3. If fully implemented, the scriptless project demonstrates that issuer and investor interests are well represented in the shaping of Hong Kong infrastructure.

Design appropriate models with modern tools

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In addressing the challenges of technology, don't forget basic legal engineering: A contract comes into existence the moment that the acceptance is posted (*Adams v. Lindsell* [1818] 106 ER 250; *Henthorn v Fraser* [1892] 2 Ch 27).

Proposals for Hong Kong

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1. Retain stamp duty and other fees, to encourage trading on fundamentals.
2. Avoid haphazard and piecemeal shift to orbiting ATSs and MTFs.
3. Look toward a Chinese securities market linking major centers in China, MiFID style.
4. Eventually create a network-based trading system with regulation in the hands of an independent agency funded by stamp duties and listing fees.