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**Panel on Financial Affairs**

**Special meeting on 28 January 2013**

**Updated background brief on proposal of the Hong Kong Exchanges and Clearing Limited to introduce after-hours futures trading**

**Purpose**

This paper provides background information on the proposal of the Hong Kong Exchanges and Clearing Limited ("HKEx") to introduce after-hours futures trading ("the AHFT proposal"), and summarizes the concerns and views expressed by Members in the 2011-2012 session.

**Background**

After-hours futures trading in overseas markets

2. According to the Administration and the Securities and Futures Commission ("SFC"), major futures exchanges around the world such as CME Group of the United States ("US"), Eurex and NYSE Liffe of Europe, Australian Stock Exchange, Singapore Exchange, Osaka Securities Exchange of Japan, etc., all have started after-hours futures trading successively to facilitate hedging activities since many years ago. The trading hours of these exchanges' stock index futures range from 14 to 23 hours per business day. The volume of after-hours trading ranges from 15% to 37% of the trading volume in the respective day sessions.

3. At present, both the cash and futures markets of Hong Kong are closed at night. When major financial news or events break out in Europe or the US after the close of Hong Kong market, the impact can only be reflected on the following business day and investors can either passively sit on their positions

until the next business day or to proxy hedge their positions through overseas derivatives markets.

#### Consultation on the proposal to introduce after-hours futures trading

4. In May 2011, HKEx published a public consultation paper to seek market comments on the AHFT proposal. As set out in the consultation paper, the strategic and business reasons for HKEx to provide AHFT are as follows:

- (a) Investors will benefit from having an AHFT platform to hedge or adjust their positions in response to market news and events in the European and US time zones;
- (b) With Hong Kong becoming a Renminbi ("RMB") offshore centre, after-hours trading will enable HKEx to serve international trading interest relating to RMB products in the future;
- (c) The capability for after-hours trading is a prerequisite for HKEx to support asset classes traded on a global basis including commodities and foreign exchange;
- (d) Given overseas exchange experience, AHFT should be a source of business growth; and
- (e) Over time, AHFT can attract European and US investors to participate in HKEx's derivatives market both during and after their working hours.

5. In December 2011, HKEx published the consultation conclusions on the AHFT proposal. According to HKEx, a total of 455 responses were received, amongst which 353 or some 78% of the respondents supported the proposal, including 67 futures market exchange participants which represented 80% of Hang Seng Index ("HSI") futures and H-shares Index ("HHI") futures market share in the first half of 2011.

#### Finalized after-hours futures trading proposal

6. After considering the comments from market participants in the consultation, assessing the technical and operational feasibilities on the brokers' side and discussion with the executives of SFC, HKEx has finalized the AHFT proposal as in **Appendix I**. The key features of the finalized proposal are as follows –

- (a) Products: Initially, HSI futures, HHI futures and gold futures will be traded in the after-hours trading session ("T+1 Session"), followed by Mini HSI futures, Mini HHI futures, RMB currency futures and BRICS futures subject to market readiness at the next stage.
- (b) Trading hours of the T+1 Session: The operating time of the T+1 Session will be from 5:00 pm to 11:00 pm, i.e. 45 minutes after the close of the regular trading session ("T Session").
- (c) Clearing and settlement: All trades transacted in the T+1 Session will be registered as T+1 trades and be cleared and settled on the following trading day.
- (d) Risk management: HKEx will manage the risk of AHFT through appropriate regular, ad-hoc and/or real time monitoring during the T+1 Session and a new mandatory variation adjustment and margin call arrangement following the market open of each T Session and payable by 12:00 noon.
- (e) Price limit mechanism: To address concern about potential undue volatility in the AHFT session, HKEx will implement a 5%<sup>1</sup> price limit up/down mechanism during the T+1 Session. No sell order of price below 95% and no buy order of price above 105% of the last traded price of the spot month contract in the T Session will be allowed. Trading (for all contract months) will be allowed only within the price limit range during the T+1 Session. HKEx will review and may adjust the proposed percentage for the price limit according to how often the limit is triggered and other experience with the limit in practice.

7. HKEx has completed software development and internal testing for AHFT, and will submit the necessary rule amendments for approval by SFC<sup>2</sup>. Subject to SFC's approval, HKEx plans to implement AHFT in March or April 2013.

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<sup>1</sup> According to HKEx, the +/-5% price limit for AHFT has been the tightest trading range allowed by international standard. If the price limit is set too low, the anticipated number of times when the market is limited will be frequent which will not be desirable for an orderly traded futures market and will severely curtail the benefit of enabling market participants to hedge exposures during after-hours in the traded futures market.

<sup>2</sup> According to Schedule 1 and Schedule 10 to the Securities and Futures Ordinance (Cap. 571) ("SFO"), the Hong Kong Futures Exchange Limited, of which HKEx is the holding company, is a recognized exchange company under SFO. Section 24 of SFO stipulates that no rule of a recognized exchange company or any amendment thereto shall have effect unless it has SFC's approval in writing.

## **Major concerns/views expressed by Members**

### Oral question at Council meeting on 23 May 2012

8. At the Council meeting on 23 May 2012, Hon WONG Kwok-hing raised an oral question regarding the AHFT proposal. Mr WONG expressed concern that in conducting the consultation on the concerned proposal, HKEx might not have given a clear account of the positive and negative impacts as well as the risks of the proposed initiative. Mr WONG called on the Administration to request HKEx to temporarily suspend its plan to implement AHFT and conduct consultation afresh on the proposal. Mr WONG also queried the appropriateness of HKEx's treating of the submission of the Hong Kong Securities and Futures Professionals Association ("HKSFPA"), which consisted of a few thousand participants in the industry, as merely a single response in the consultation conclusions. Mr WONG further queried why the Legislative Council ("LegCo") was not consulted on the AHFT proposal in advance.

9. The Secretary for Financial Services and the Treasury responded that in accordance with section 21 of the Securities and Futures Ordinance (Cap. 571), HKEx shall manage the risks associated with its business and operations prudently, act in the interest of the public, having particular regard to the interest of the investing public, and ensure that the interest of the public prevails where it conflicts with the interest of the exchange. In assessing the AHFT proposal, SFC would take into account its potential impact on the Hong Kong financial market, and relevant risk management measures. The results of HKEx's consultation showed that the majority of industry and market participants supported the implementation of AHFT. As such, the Administration shared the views of the HKEx and SFC that it was not necessary to consult the public again on the same subject.

### Discussion at the Panel on Financial Affairs meeting on 10 July 2012

10. The AHFT proposal was discussed at the meeting of the Panel on Financial Affairs ("FA Panel") on 10 July 2012. The major concerns/views expressed by Panel members and the responses from the Administration, SFC and HKEx are summarized in the paragraphs below.

#### *Consultation with the industry*

11. Hon WONG Kwok-hing reiterated the concerns expressed by the industry, including the absence of bank services during which might increase the risk of close-out of the futures contracts concerned and the loss on the part of investors, and the proposed 5% price capping on the futures transactions during AHFT.

Members noted from HKSFPA's submission of its objection to the AHFT proposal, and its request for the Panel to hold a public hearing on views from the industry and the public. SFC and HKEx advised that AHFT had been practiced in most futures markets in the world. HKEx would make efforts to explain the details of the proposal to the parties concerned, and where appropriate refine the arrangements. SFC and HKEx would also review the arrangements after AHFT had been implemented. To address Mr WONG's concerns, the Administration undertook to provide an information paper to the FA Panel after commencement of the fifth term of the LegCo so that the Panel could decide whether and how to follow up the issue.

*Risks to investors*

12. A Panel member pointed out that it might not be necessary for investors in Hong Kong to manage their position during the night as the futures price level might return to normal when the Hong Kong market opened in the following day. With the introduction of AHFT, investors might have to hedge their position, or if they could not raise capital to hedge their position during the AHFT session, they might be forced to close out their futures contracts and they might suffer losses.

13. SFC and the Administration explained that, with the introduction of AHFT in Hong Kong's stock market, investors could manage their HKEx's index futures positions during Hong Kong night time at real time against any major market news and movement in the European or US markets. Some of the futures trading and hedging needs in response to overnight news and events would be satisfied in the AHFT session. As such, overnight buying and selling pressures in the futures market would not be concentrated in the futures market opening period in the next morning and the volatility and magnitude of the futures market price movement at the opening could be reduced.

14. On the proposed 5% price limit during AHFT session, HKEx explained that the cap was proposed in response to industry's concern on risk management. The 5% cap was similar to the arrangement in the US futures market. Other risk management measures would be put in place, such as the payments of margins for transactions during AHFT would be based on the prices of the contracts listed during the auction time of the next trading day and settled when the futures market opened in the following day.

### **Latest development**

15. The Administration provided an information paper on the finalized arrangements of AHFT, which was issued to FA Panel members on 2 January 2013 (LC Paper No. CB(1)362/12-13(01)). The FA Panel will receive views from deputations on the AHFT proposal and discuss related matters with the Administration, SFC and HKEx at the special meeting to be held on 28 January 2013.

### **Relevant papers**

16. A list of relevant papers is given in **Appendix II**.

Council Business Division 1  
Legislative Council Secretariat  
23 January 2013

### **Final Proposal on After-hours Futures Trading**

After-hours futures trading with regard to products, trading, clearing and risk management will be implemented as follows:

#### **a) Products**

At the initial stage, HSI futures, HHI futures and gold futures would be introduced for after-hours trading. Subject to the development of trading liquidity in the main stock index futures contracts, mini-HSI futures and mini-HHI futures will be introduced at the next stage. Trading arrangements of the stock market will not be affected. As and when market conditions warrant, HKEx might also consider introducing other existing or new derivatives products for after-hours trading in the future.

#### **b) Trading**

##### **i. Proposed Trading Hours**

A new trading session (T+1 Session) will be introduced in the futures market. The opening time of the T+1 Session will be 45 minutes after the close of the regular trading session (T Session), i.e. 5:00 p.m. for stock index futures and gold futures. Trades executed during the T+1 Session (T+1 Trades) will be registered as the following day's trades.

The T+1 Session will end at 11:00 p.m.

##### **ii. Holiday Arrangements**

If it is a Hong Kong public holiday or there is half-day trading in the HKEx securities market or it is a bank holiday in both the UK and United States, there would be no T+1 Session on that day.

##### **iii. Typhoon or Black Rainstorm Arrangements**

If a Typhoon Signal No. 8 or above or a Black Rainstorm Warning is hoisted and is not lowered before 12:00 noon, there would be no T+1 Session on that day.

#### iv. Order Types

All rest of day orders, until expiry orders and specified date orders, by default, will be effective only in T Session and outstanding orders will be carried forward to the next T Session and so on whilst outstanding.

For Exchange Participants (EPs) and their clients participating in after-hours trading need to select the order attribute "T+1" when entering their rest of day orders, until expiry orders and specified date orders for those orders that should be effective for both T Session and the T+1 Session. These orders with "T+1" attribute will be carried forward from T+1 Session and back into T Session and so on whilst outstanding.

Fill-or-kill orders and fill-and-kill orders which are to be executed (or not) immediately, the order attribute "T+1" will not be applicable and will be ignored.

#### v. Price Limit Up/Down Mechanism

The proposed percentage for the price limit up/down is 5%. HKEx will review and may adjust the proposed percentage for the price limit according to how often the limit is triggered and other experience with the limit in practice.

No sell order of price below 95% and no buy order of price above 105% of the last traded price of the spot month contract in the T Session will be allowed. Trading (for all contract months) will be allowed only within the price limit range during the T+1 Session.

Notes: Trading in the T Session will not be subject to this price limit up/down mechanism.

#### vi. Handling of Error Trades

Existing error trade rules will apply in the T+1 Session.

#### vii. Block Trade Facility Not Applicable

At the initial stage, the Block Trade Facility will not be available in the T+1 Session. HKEx will consider introducing the Block Trade Facility when options products are available for trading in the T+1 Session.



c) **Clearing**

i. Clearing of Trades Executed in T+1 Session

T+1 Trades will be registered as the following day's trades. Together with trades executed in the following day's T Session, these trades will undergo the standard clearing process during the standard clearing session (T Clearing Session). With after-hours futures trading, the T Clearing Session will start 1 hour earlier than the T Session for respective futures products. T Clearing Session ends at 6:45 p.m. i.e. existing System Input Cutoff Time.

In addition, a new clearing session (T+1 Clearing Session) will be introduced. The T+1 Clearing Session will start at the same time as the T+1 Session and end 45 minutes after the close of the T+1 Session (i.e. 11:45 p.m.).

A comparison of time windows for existing and proposed clearing sessions is as follows:

<b>Product</b>	<b>Time Window</b>	<b>T Clearing Session</b>	<b>T+1 Clearing Session</b>
<b>HSI/HHI Futures</b>	Existing Time Window	8:45 a.m. – 6:45 p.m.	N/A
	Proposed Time Window	7:30 a.m. – 6:45 p.m.	5:00 p.m. – 11:45 p.m.
<b>Gold Futures</b>	Existing Time Window	8:30 a.m. – 6:45 p.m.	N/A
	Proposed Time Window	7:30 a.m. – 6:45 p.m.	5:00 p.m. – 11:45 p.m.

This dual clearing session arrangement enables trading during T+1 Session (whereby executed trades are registered as T+1 Trades) and day-end processing of T trades to take place concurrently. Clearing Participants (CPs) can still process post-trade activities on T trades as normal during the T Clearing Session while trading can take place under T+1 Session.

ii. Position Recording

Positions will be maintained according to clearing dates and separate records are held at all times for T day and T+1 day positions. T day positions will be finalized after the end of T Clearing Session at 6:45 p.m. and subject to day-end margin calculation. T+1 day positions will be finalized after the end of T+1 Clearing Session at 11:45 p.m. These T+1

day positions will become T day opening positions on the following day, i.e. the following day's positions are made up of positions created during the T Session on that day plus trades / post-trades executed during the T+1 Session of the previous day.

d) **Risk Management**

In the absence of a level of banking support to facilitate intra-day call capability during the T+1 Session similar to that during the T Session, the following additional risk management measures will be implemented to mitigate the counterparty risks associated with after-hours futures trading.

- i. Perform monitoring of CPs' capital based position limit (CBPL) based on both the current market prices and positions at regular intervals during the T+1 Session, supplemented by ad-hoc CBPL monitoring. CPs breaching their CBPL may be requested to reduce their exposures to re-establish compliance with their CBPL and risk being disconnected from the HKEx trading system and closing out action should they fail to comply with such request or further increase their exposure.
- ii. A mandatory variation adjustment and margin call to markets (based on the morning Calculated Opening Prices<sup>1</sup>) with T+1 Session will be introduced following the market open of each T Session to collect by 12:00 noon both mark-to-market loss and margin of all positions including that created by trades in T+1 Session. The Calculated Opening Price is the equilibrium market price derived from the price discovery period of thirty minutes before the opening of the morning trading session.
- iii. There will be no intra-day variation adjustment or margin call during the T+1 Session.

(Source: Appendix to Annex of the information paper provided by the Administration on "Proposal of the Hong Kong Exchanges and Clearing Limited to introduce after-hours futures trading" (LC Paper No. CB(1)362/12-13(01))

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<sup>1</sup> If the Calculated Opening Price is not available, market price shortly after the market open will be used.

## Appendix II

### List of relevant papers

Date	Event	Paper/Minutes of meeting
May 2011	Consultation on after-hours futures trading ("AHFT") conducted by the Hong Kong Exchanges and Clearing Limited ("HKEx")	<a href="#"><u>Consultation paper</u></a>
December 2011	Consultation conclusions on AHFT conducted by HKEx	<a href="#"><u>Consultation conclusions</u></a> <a href="#"><u>Press release</u></a>
23 May 2012	Oral question raised by Hon WONG Kwok-hing on AHFT at the Council meeting	<a href="#"><u>Hansard</u></a> (page 40-49)
10 July 2012	Meeting of the Panel on Financial Affairs	<a href="#"><u>Discussion paper</u></a> (LC Paper No. CB(1)2286/11-12(01))  <a href="#"><u>Background brief</u></a> (LC Paper No. CB(1)2285/11-12)  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)2636/11-12)
January 2013	-	<a href="#"><u>Information paper provided by the Administration on the proposal of HKEx to introduce AHFT</u></a> (LC Paper No. CB(1)362/12-13(01))