

# 立法會

## *Legislative Council*

LC Paper No. CB(1) 2047/99-00  
(These minutes have been seen  
by the Administration and  
cleared by the Chairman)

Ref : CB1/BC/2/99/2

### **Bills Committee on Exchanges and Clearing Houses (Merger) Bill**

**Minutes of meeting held on  
Tuesday, 23 November 1999, at 8:30 am  
in Conference Room A of the Legislative Council Building**

- Members present** : Hon Ronald ARCULLI, JP (Chairman)  
Hon LEE Kai-ming, SBS, JP  
Hon NG Leung-sing  
Hon CHAN Kam-lam  
Hon SIN Chung-kai  
Hon Jasper TSANG Yok-sing, JP
- Members absent** : Dr Hon Philip WONG Yu-hong  
Hon FUNG Chi-kin
- Public officers attending** : Mr Bryan P K CHAN  
Principal Assistant Secretary for Financial Services  
  
Ms Gloria LO  
Assistant Secretary for Financial Services  
  
Ms Mabel CHEUNG  
Government Counsel  
Department of Justice
- Attendance by invitation** : Mr Gerald D GREINER  
Senior Director of Supervision of Markets  
Securities and Futures Commission

**Clerk in attendance** : Ms LEUNG Siu-kum  
Chief Assistant Secretary (1)4

**Staff in attendance** : Mr KAU Kin-wah  
Assistant Legal Adviser 6

Ms Connie SZETO  
Senior Assistant Secretary (1)1

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## **I Election of Chairman**

Proposed by Mr CHAN Kam-lam and seconded by Mr LEE Kai-ming, Mr Ronald ARCULLI was elected the Chairman of the Bills Committee.

## **II Meeting with the Administration**

(LC Papers No. CB(1)424/99-00(01) - (03), CB(3)175/99-00, LS26/99-00 and LegCo Brief ref: SUB56/7(99))

2. The Principal Assistant Secretary for Financial Services (PAS/FS) explained that the purpose of the Exchanges and Clearing Houses (Merger) Bill (the Bill) was to provide the necessary legal framework for the implementation of the merger reform under which the Hong Kong Exchange and Clearing Limited (HKEC) was formed through demutualization and merger of the Stock Exchange of Hong Kong (SEHK), the Hong Kong Futures Exchange, the Hong Kong Securities Clearing Company Limited (HKSCC), the SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKFECC). The main object of the Bill was to facilitate the regulation of the recognized exchange controller (REC). HKEC would be deemed to be a REC upon commencement of the Bill and therefore be subject to the proposed regulatory regime. Major provisions in the Bill included the recognition and withdrawal of recognition of a company as REC, duties of and regulation for REC, and the establishment of the Risk Management Committee, transitional arrangements including appointment of persons to the Board of Directors of HKEC (HKEC Board) and conversion of HKSCC from a company limited by guarantee to a company limited by shares. There would also be consequential amendments to other ordinances including the Securities Ordinance (Cap. 333), the Securities and Futures Commission (SFC) Ordinance (Cap. 24), the Stock Exchanges Unification Ordinance (Cap. 361), the Prevention of Bribery Ordinance (Cap. 201), and the Legislative Council (Amendment) Ordinance 1999 (No. 48 of 1999). The majority of these amendments were related to the conversion from "members", "stockbrokers" and "shareholders" to "exchange participants".

3. PAS/FS informed that the schemes of arrangements containing the details of the terms of the merger proposal were approved by members of the exchanges on 27 September 1999 and subsequently sanctioned by the court on 11 October 1999. On the legislative timetable, PAS/FS said that the target of the Administration was to enact the Bill in late January or early February 2000. If the Bill was not passed before the end of March 2000, the merger deal would lapse unless the court approved a later expiry date for the schemes of arrangements.

#### The merger

4. Responding to members enquiries, PAS/FS explained that after the merger, SEHK, HKFE, HKSCC, SEOCH and HKFECC would remain as separate corporate entities under the single holding company of HKEC. While SEHK, HKFE and HKSCC would become wholly-owned subsidiaries of HKEC, SEOCH and HKFECC would remain wholly-owned subsidiaries of the two exchanges. Such corporate structure would facilitate the merger to take place expeditiously.

5. On Mr CHAN Kam-lam's enquiry about the consideration of not merging the three clearing houses in this merger reform, PAS/FS responded that there were technical difficulties in merging the three clearing houses at the present stage. He explained that the merger of clearing houses required the creation of common clearing and settlement infrastructure with appropriate risk management systems for protection of the interests of the market participants. The subject matter had been considered by the Steering Committee on the Enhancement of Financial Infrastructure. The Committee submitted recommendations for improving Hong Kong's financial infrastructure to the Financial Secretary (FS) by the end of September 1999. Taking into account the views of the Committee, HKEC and the industry, the Administration concurred that the integration of the three clearing houses should only take place after careful planning. The Administration envisaged that complete merging of the infrastructure of the three clearing houses would take about one or two years. Hence, it was considered appropriate to pursue the matter under a separate exercise so that the merger reform would not be delayed and could be implemented as early as possible to enable Hong Kong's market structure to meet the global and external challenges. PAS/FS remarked that many major overseas exchanges including the Deutsche Bourse, the Stockholm Exchange and the Amsterdam Exchange had already undergone similar market reform. The Australian Stock Exchange was demutualized and listed in 1998. Singapore had also announced its plan to demutualize and merge its stock market and derivatives market by end 1999. It was necessary for Hong Kong to undertake market structure reform quickly in order to improve market efficiency, enhance its competitiveness and maintain Hong Kong's status as a major international financial centre. He added that the Administration also made reference to market reform experience of overseas exchanges. It was

worth noting that the demutualization of the Australian Stock Exchange had been implemented progressively with the merger of the securities and futures markets taking place shortly after the corporatization of the securities market.

### Framework of checks and balances

#### *Governance structure*

6. PAS/FS informed that HKEC was incorporated as a private company under the Financial Secretary Incorporation at the moment. The Government would maintain only two shares of the company after the merger.

7. Members queried the strong government influence on HKEC. As the appointment of the Chairman of HKEC would be subject to the approval of the Chief Executive who could also remove the Chairman from office, and that eight out of the 15 members of HKEC Board would be appointed by FS, members were concerned that the proposed governance structure would constrain HKEC in pursuit of commercial objectives and undermine shareholders' interests. The Chairman cautioned that as HKEC Board was the highest decision-making body of the company, the proposed corporate structure would lead to the wrong impression that the Government actually run the company and there might even be the danger that the Government would be liable for decisions made by HKEC Board. Mr SIN Chung-kai urged the Administration to provide information on experience of merger and demutualization of overseas exchanges including their new corporate structures after the merger, composition of their boards, as well as the regulatory regimes they were subject to.

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8. In response, PAS/FS stressed that while HKEC was a commercial entity, it had important public roles, such as ensuring a fair and orderly market and managing risks prudently. As such, it was necessary to put in place a comprehensive framework of checks and balances for regulation of HKEC. The Administration was of the view that the proposed governance structure for HKEC was appropriate as it would ensure the company be run properly in pursuit of both the public and commercial objectives and be able to strike a right balance where these objectives conflict with each other. PAS/FS stressed that the Administration had no intention to control HKEC. The provision for FS to appoint members of HKEC Board was only a transitional arrangement to ensure that public functions of HKEC would be properly carried out. With the diversification of the shareholding of HKEC over time, the Administration envisaged that the representation of the shareholders' interest in the Board would increase. PAS/FS remarked that while the inaugural board (from March 2000 onwards for a period of three years) would be composed of 15 members with six members to be elected by shareholders of HKEC, eight to be appointed by FS, and the Chief Executive Officer being an ex-officio member, the Administration would review the composition of future HKEC boards in 2003.

Admin Taking into account the actual commercial and operational needs of HKEC at the time and the pace of diversification of shareholding in HKEC, the structure of HKEC Board would be subject to change. PAS/FS further assured members that FS appointed board directors would represent public and market interests. In view of members' concern, PAS/FS nevertheless undertook to re-consider the issue of the composition of HKEC Board.

*Risk management*

Admin 9. Members noted that decisions made by the Risk Management Committee (RMC) would prevail unless overruled by two-third majority of all directors of HKEC Board. Mr SIN Chung-kai expressed concern that without specifying clearly in the Bill the duties and functions to be performed by RMC, the power of RMC could be excessive. He requested the Administration to provide information on parallel structures in overseas demutualized exchanges.

Admin 10. PAS/FS said that under the existing market structure risk management for the markets was undertaken by respective boards of the clearing houses. The formation of an independent RMC within HKEC after the merger was to ensure that HKEC would perform the risk management function for the clearing unit in a prudent manner and to prevent any compromise of such function by profit-related considerations. RMC would be chaired by the Chairman of HKEC personally and comprised a maximum of seven other members. FS would appoint no less than three and no more than five members from the market regulators (including SFC and the Hong Kong Monetary Authority) and market experts. There would be no more than two members appointed by HKEC Board. He stressed that RMC would only be responsible for making policies on risk management matters and its recommendations had to be submitted to HKEC Board for approval. RMC would not become the decision making body of HKEC. To address members' concern, PAS/FS undertook to re-consider the composition and power of RMC.

*Shareholding limit*

11. PAS/FS briefed members that shareholding limits were set to prevent control of HKEC by any parties. He explained that the Bill provided that no person could control directly or indirectly an exchange company or a clearing house unless it was a REC. Any person who, either alone or with any associate(s), exercised or control the exercise of more than 35% of the voting power of an exchange company or clearing house would be deemed to be in control of that exchange company or clearing house. Any changes in such controller's shareholding in this respect would require SFC's approval. In this context, any changes in the shareholding of HKEC over its subsidiary exchange companies and clearing houses would require the approval of SFC. PAS/FS added that a 5% shareholding limit was also specified in the Bill to prevent control of a REC, an exchange company or clearing house by any person either

alone or with any associate(s). No person could exercise or control the exercise of more than 5% of the voting power of a REC, an exchange company or a clearing house without the approval of SFC after consultation with FS. Exemptions from such shareholding limits would be granted in the interest of the public and the market.

### *Listing of HKEC*

12. PAS/FS explained that HKEC and SEHK would continue to enforce the listing rules in respect of companies listed on SEHK. However, in order to remove possible conflict of interest which would arise when HKEC and its subsidiaries sought to be listed on SEHK, the Bill provided SFC with power to direct HKEC or its subsidiaries to take steps to remedy any such conflict of business interest whenever appeared. This would ensure a level playing field on the stock market between HKEC group and other listed companies.

13. In this connection, members opined that it would be more desirable to restrict the operation of HKEC to securities and futures business and associated settlement and clearing systems so that any possible conflict of interest mentioned above could be reduced to the minimum.

14. PAS/FS responded that although HKEC had certain public duties, it was a profit-driven commercial entity. The Administration considered it inappropriate to restrict the scope of its business as long as its public functions were performed. He said that the Bill had clearly specified the company's objects which included, inter alia, to ensure the operation of orderly and fair markets and prudent management of risks with due regard to the interests of the investing public and the public interest. Coupled with SFC's power to direct HKEC to take action when a conflict existed between the business interest of HKEC and its public functions, the Administration believed that there were sufficient checks and balances on HKEC.

15. Members were unconvinced of the Administration's explanation. Mr SIN Chung-kai pointed out that there were provisions in the Mass Transit Railway Corporation Ordinance (Cap. 270) specifying the permitted activities of the corporation and required special approval be sought if the scope of activities was to be expanded. The Chairman also remarked that the Hong Kong Mortgage Corporation Limited aiming at promoting the development of the secondary mortgage market, was also restricted from undertaking mortgage business in the primary market which was conducted by financial institutions. Members requested the Administration to provide a paper on the scope of business prescribed for overseas demutualized exchanges and setting out the Administration's consideration for not restricting the scope of business of HKEC.

### Rationalized market regulation

16. PAS/FS advised that the division of market regulatory functions between SFC and HKEC would essentially follow the current model applicable to the exchanges and clearing houses. After the merger, SFC would remain to be responsible for detecting market malpractices with statutory implications. All prudential regulation of exchange participants would be handled by SFC. HKEC and its exchange and clearing subsidiaries would monitor particular aspects of the business of the exchange participants which included the administration and enforcement of the trading, listing and clearing rules. Mr Gerald GREINER, Senior Director of Supervision of Markets, SFC supplemented that in respect of intermediaries supervision, SFC would take over the responsibility from HKEC to monitor compliance of exchange participants with conduct rules and various requirements under the Financial Resources Rules. The new division of function between SFC and HKEC would remove the existing problem of duplication in supervision of intermediaries who were also members of the exchanges. While existing members of the exchanges would be "grandfathered" market access, new exchange participants had to seek appropriate registration with SFC and to satisfy SFC's "fit and proper" criteria in this respect. As regards regulation of HKEC, SFC would continue to have supervisory power over HKEC and its subsidiary exchanges and clearing houses. Apart from SFC's current function of approving their constitutions and rules, the launch of new financial products etc., any fees and charges to be imposed by HKEC or its subsidiary exchanges and clearing houses would be subject to the approval of SFC.

### Trading right

17. Pointing out that there would be a moratorium on the issue of new trading rights (except in the case of alliance with other exchanges) for a period of two years from the coming into effect of the merger, some members were concerned that open access to the trading facilities, which was one of the objectives of the merger reform, would not be ensured. Mr CHAN Kam-lam opined that there should be provisions in the Bill ensuring the opening up of market access.

18. PAS/FS advised that the shareholding of the exchanges and the right to trade on and through the respective exchanges would be separated after the merger. As such, each current member of the exchanges would be issued a trading right in their respective exchanges for each share held in the respective exchanges. Such trading right could only be transferred one time within a period of ten years from the coming into effect of the merger.

19. On the concern about opening up of market access, PAS/FS stressed that while the Administration fully recognised the advantage of increasing market access to enhance global competitiveness of the exchanges, it shared the

industry's concern that an abrupt opening of the market would create an excessive burden on existing members of the exchanges and might adversely affect the viability of their business. In order not to undermine existing members' confidence in the merger reform, the Administration agreed that opening up of the market should be undertaken in a progressive manner and accepted proposals of imposing a moratorium on the issue of new trading rights and transferability conditions of such rights. PAS/ES advised that the proposed arrangements in respect of trading rights were only transitional. Notwithstanding that the pace of opening up the market would be a matter for HKEC to determine in consultation with SFC, HKEC as the market operator, would surely have incentive to open up the market and enhance its competitiveness to bring about commercial benefits for HKEC. Moreover, there would be no barrier to the market as trading rights were available for purchase in the secondary market. In addition, given the rapid development in new modes of trading, such as internet, it was believed that market access would be unrestricted and regulated through market forces.

20. As regards the proposed minimum fees of \$3 million and \$1.5 million to be imposed on a SEHK trading right and a HKFE trading right respectively for the next two years after the moratorium, PAS/ES said that the levels more or less reflected the market prices for transferring of members' trading rights at the time when the merger proposal was finalized in July 1999.

21. Concerning the granting of trading rights to members of foreign exchanges forming alliances with HKEC, PAS/ES said that formation of strategic alliances with overseas exchanges would be essential to enhance the competitiveness of local markets in response to rapid development of globalization of financial markets. Hence, it was proposed that HKEC should be given flexibility to grant new trading rights to members of overseas exchanges on appropriate terms to facilitate the formation of alliances. HKEC should made such decisions prudently and in consultation with SFC with consideration on the risk management implications and reciprocity in the proposed alliance arrangements.

#### Conversion of HKSCC

22. PAS/ES informed that to complete the merger, it was necessary to convert HKSCC from a company limited by guarantee to a company limited by shares. The Bill would empower members of HKSCC to amend its constitution to achieve this purpose and lay down clear procedural steps for the conversion process. As regards usage of the existing assets of HKSCC, PAS/ES said that they would be kept as reserves of HKEC for the development of market infrastructure and risk management systems in respect of the clearing and settlement unit.

### Re-delineation of the Financial Services Functional Constituency

23. Some members expressed concern about the possibility that some 21 non-trading active members of SEHK would not be eligible to become electors due to the proposed re-delineation of the Financial Services Functional Constituency (FSFC) as pointed out in paragraph 29 of the LegCo Brief. PAS/FS explained that the Legislative Council (Amendment) Ordinance 1999 (No. 48 of 1999) provided that members of the two exchanges who were eligible to vote at their general meetings would be eligible to be registered as electors for FSFC. In accordance with the constitution of SEHK, members of SEHK who were not trading on the market but whose membership remained "active" (i.e. not suspended) were entitled to vote at general meetings and therefore eligible to become electors of FSFC. In respect of HKFE, only shareholders who were trading were admitted as members. It followed that non-trading shareholders could not become members of HKFE and therefore could not be entitled to vote at the general meetings and not eligible for elector registration under the current delineation of FSFC. Given the separation of the shareholding of the two exchanges from the right to trade on and through the respective exchanges following the merger reform, the current composition of FSFC needed to be changed. The Bill provided that existing members of the exchanges would be deemed to be exchange participants and be allowed to continue to trade on or through the exchanges after the merger. In the case of SEHK, only those members who were not admitted as "exchange participants" by SEHK, due to the suspension or revocation of their registration with SFC, would become ineligible for elector registration. As far as HKFE members were concerned, the proposed re-delineation should be neutral to them.

24. PAS/FS stressed that although the industry had expressed concern about the issue, the proposed re-delineation of FSFC would not disadvantage current non-trading but active members of SEHK and make them ineligible for elector registration of FSFC. Even under the current delineation, whenever the membership of these non-trading SEHK members were suspended, which might be due to disciplinary actions or revocation of licence by SFC or failure to pay dues to SEHK, they could not be entitled to vote at SEHK general meetings and as a result not entitled to register as electors of FSFC.

### **III Any other business**

25. Members agreed to schedule the following four meetings to continue discussion with the Administration on the Bill -

<u>Date</u>	<u>Time</u>
29 November 1999	10:45 am
30 November 1999	8:30 am

1 December 1999	8:30 am
6 December 1999	8:30 am

26. There being no other business, the meeting ended at 10:30 am.

Legislative Council Secretariat

18 September 2000