

Responses to Market Submissions

This note sets out the response of the Administration to the submissions on the Exchanges and Clearing Houses (Merger) Bill ("the Bill") by the Securities and Futures Market Reform Members' Concerns Coordinating Group ("the Group"), the Institute of Securities Dealers ("the Institute"), the Hong Kong Stockbrokers Association ("HKSbA") and the Hong Kong Society of Accountants ("HKSA").

I. Securities and Futures Market Reform Members' Concerns Coordinating Group

Trading Rights

As set out in the Scheme of Arrangement documents of the two exchanges for the merger, the ownership of shares in the exchanges or, after the merger, the Hong Kong Exchanges and Clearing Limited ("HKEC") and access to the trading facilities of the exchanges will be separated upon merger. Persons who are shareholders of the two exchanges immediately prior to the coming into effect of the merger will be issued one trading right per each share they hold of the respective exchanges ("the grandfathered trading rights"). The trading right will confer on its holder the eligibility to trade on the relevant exchange (such eligibility is presently derived from the holding of shares in the exchanges). The holding of the trading right however will not, of itself, permit the holder to actually trade on or through the exchanges unless the holder is also admitted as an exchange participant in accordance with the respective rules of the exchanges.

2. "Grandfathered" trading rights may be transferred once in the first 10 years from the merger. Such transferability will lapse thereafter. The HKEC Board has also determined that HKEC will establish a moratorium on the issue of new trading right (save for such rights as may be issued in respect of alliances with other futures exchanges or stock exchanges) for a period of two years from the coming into effect of the merger. For a further period of two years thereafter, no trading rights will be issued for less than HK\$1.5 million per Futures Exchange trading right and not less than \$3.0 million per Stock Exchange trading right. Such "new" trading rights issued by the HKEC will however not be transferable.

3. Clause 23 of the Bill provides that existing members of the two exchanges will be deemed to be exchange participants upon the coming into force of the Bill, provided that they continue to be validly registered with the

SFC as dealers. Other issues relating to the transfer of trading rights, including the moratorium and fees for such transfers as set out in the Scheme documents are essentially commercial matters for the HKEC and are not intended to be dealt with by the Bill.

Clause 9 – Establishment and functions of the Risk Management Committee

4. The concept of Risk Management Committee ("RMC") is explained in detail under Chapter 4 of the paper entitled "Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre" ("the July Paper"). At present, major decisions relating to risk management functions of the market are made by various bodies of the different market institutions, including the boards and in some instances the functional committees of the three clearing houses and the two exchanges. Daily operation of the risk management functions are delegated to the staff level who act in accordance with prescribed rules.

5. As pointed out in the Paper, risk management is an important function of the HKEC that will have profound implications for the rest of the financial system. To centralise the risk management functions across the different market segments and throughout the various operations, it was proposed that a RMC be established to deal with matters relating to the risk management of the HKEC and its subsidiary exchanges and clearing houses. The RMC will be a critical component of the risk management function under the merged corporate structure of the HKEC to ensure that such function will be performed in a prudent manner without being unduly affected by the profit-making considerations of HKEC.

6. Paragraph 4.9 of the July Paper (extract at Appendix I) states that the RMC should be chaired by the Chairman of the HKEC and comprise a majority of external board members of HKEC, including representatives of market regulators including the SFC and the HKMA, relevant market experts and public interest representatives. It further suggests that the decision of the RMC will prevail unless overruled by, say, a two-third majority of the Board of the HKEC. In exhibit 5.2 of the Paper which shows the board committees and panels of the HKEC, it is suggested that the RMC would be made up of 3 HKEC directors (including one as chairman) and 3 to 5 external members (appointed by the HKEC board). Subsequently in Appendix VI to the Scheme of Arrangement documents of the SEHK and the HKFE circulated to members prior to their voting on the merger (extract at Appendix II), it is stated that both the Financial Secretary and the HKEC board may appoint persons as members of the RMC and that the decision of the RMC may only be overruled by a two thirds majority of the HKEC board.

7. The current provision of the Bill broadly reflects the model of the RMC as described above. Given the functions of the RMC to manage risk prudently and to balance the commercial interests of the HKEC vis-à-vis its risk management functions, the Administration considers it important and appropriate that it comprises a majority of members from outside the HKEC board and that they be appointed by the Financial Secretary, instead of the HKEC board. As provided for under the Bill, the HKEC Board may appoint a maximum of two members to the RMC.

8. As we have previously clarified to the Bills Committee, we do not believe the RMC will overshadow the board of the HKEC as the purview of the former is confined to risk management-related matters only. Non-risk management related matters including all commercial matters of the HKEC will be a matter of the board of HKEC.

Clause 14 – Commission may give direction to recognised exchange controller where it is satisfied that conflict of interest exist, etc

9. The proposal to provide for defense for person charged with an offence under this section is noted and would be considered in the light of the discussion at the Bills Committee.

Clause 20 – Financial Secretary may appoint not more than 8 persons to the board of directors of HKEC

10. As set out in the Bill, the Financial Secretary may appoint no more than 8 persons to the board of directors of the HKEC where he is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest. As stated in the July Paper, such directors will be appointed from among, inter alia, market professionals and members of the community who can represent the public interest. In its submission, the Group has noted its concern that there may not be a balanced representation on the board. We share this view and indeed it is for the same reason that we do not think setting out rigidly the criteria for appointment is conducive to this objective. Specifying the constituencies from which the FS may appoint HKEC directors will compromise the flexibility in the exercise of the appointment power and may not be helpful in constructing the most balanced board.

Paragraph 71 in Schedule 2 – Composition of the Financial Services Functional Constituency

11. The current law provides that members of the SEHK and members of the HKFE who are eligible to vote at their general meetings are also eligible for registration as electors of the Financial Services Functional Constituency ("FS FC"). Following the removal of the existing membership

structure of the exchanges and the separation of trading rights from the ownership of the exchanges, it is proposed that the FS FC be re-delineated by replacing “members” of the exchanges by “exchange participants” as the basis of the delineation of the FS FC after merger. Subject to the enactment of the Bill, the re-delineation will apply to the 2000 Legislative Council election.

12. The general policy for the delineation of the functional constituencies is that the electorate should be representative of and have a substantial connection with their respective sectors. After the merger, existing members of the exchanges will in principle continue to be allowed to trade on the respective exchanges in their new capacity as “exchange participants”. The Administration believes that it is in line with the general policy and the existing delineation of the FS FC that the “exchange participants” replaces “members” for the purposes of registration as electors for the FS FC.

13. Currently, there are a small number of “active” members in SEHK who are for various reasons currently not trading on the market. After the merger, these non-trading members, depending on why they are not trading, may or may not be admitted as “exchange participants” by SEHK and therefore may or may not be eligible for registration as electors of the FS FC under the proposed re-delineation. Whether they will or will not be eligible depends essentially on whether they continue to be registered by the SFC as dealers and whether they continue to run their broking business as “exchange participants”. As at late October 1999, there are altogether 21 members out of a total of nearly 600 members of the Stock Exchange whose membership is active but who are not trading.

14. The proposed re-delineation will not affect the eligibility of the members of the HKFE for registration as electors under the FS FC.

II. The Institute of Securities Dealers

Governance structure of HKEC

15. As proposed in the July Paper, there will be an Executive Committee and a Management Committee to oversee the HKEC’s daily management and to co-ordinate the operation of different units of the organisation. There will also be a number of committees and consultative panels to support and give advice to the Board of the HKEC. The July Paper also proposes that there should be a chief executive officer and a chief operating officer to oversee the management and operation of the HKEC. However, as stated in the Scheme documents, it is at an early stage in the consideration of the detailed implementation of the proposed structures of the HKEC Group and it is a commercial decision for the HKEC to decide on the most appropriate corporate structure for the Group after merger, save for those

elements which are required by the law and/or the constitution of the HKEC (such as the composition of the board and the formation of the RMC). We will convey the views and suggestions of the Institute to the HKEC for consideration. Meanwhile, we are not aware of any plans of the HKEC to substantially modify the proposed corporate structure as set out in the July Paper.

Approval to the amendment of constitution and fees

16. The current law already provides that any amendments to the constitution and rules (which include most of the fees and charges) of the exchanges and clearing houses are subject to the approval of the SFC. This requirement has been put into practice for a long time and we are not aware of any problems in its implementation. We therefore do not see any apparent reasons for the setting up of an appeal board to arbitrate the disputes between HKEC and SFC over the applications for amendment of the constitution and fees.

Market development

17. The current proposed corporate structure of the HKEC Group includes the setting up of three consultative panels for the cash, derivatives and clearing operations respectively. These panels will comprise mainly market practitioners and professionals. Their responsibility is to advise the HKEC on matters including international trends, investors' needs, technology challenges and new product opportunities. These should cover the functions of market development as proposed by the Institute. We will nevertheless convey the proposal for setting up a committee on market development to the HKEC for its consideration.

Risk Management Committee (RMC)

18. Please refer to paragraphs 4 to 8 above.

Eligibility as electors of the Financial Services Functional Constituency

19. Please refer to paragraphs 11 to 14 above.

Penalty clause for various offences

20. The level of penalties as defined under the various clauses of the Bill mean the maximum level of penalty for the relevant offences. The relevant clauses in their existing form are in line with the law drafting convention and we do not consider that there is a need for amendment to the wordings.

III. Hong Kong Stockbrokers Association

Risk Management Committee

21. Please refer to paragraphs 4 to 8 above.

Clause 14 – Commission may give directions to recognised exchange controller where it is satisfied that conflict of interest exists, etc.

22. The proposal to provide for defense for a person charged with an offence under subsection (3) is noted and will be considered in the light of the discussion at the Bills Committee.

23. The submission by the HKSbA also seeks clarification regarding clauses 14(3)(a) and (b) concerning offence committed by "individuals". As previously explained to the Bills Committee in response to a similar question raised by the Hong Kong Law Society (our letter dated 25 November 1999 to the Secretary to the Bills Committee refers), it is correct that the concerned offence would be committed by a company. The reference to an "individual" committing the offence refers to directors and other officers of the company who are individuals and guilty of the like offence by virtue of section 101E of the Criminal Procedure Ordinance (Cap.101).

Clause 20 – Financial Secretary may appoint not more than 8 persons to the board of directors of HKEC

24. Please refer to paragraph 10 above. We share the view of the submission that the board of the HKEC should have sufficient representation of different interests of the market and the public and would like to reassure the HKSbA that the Financial Secretary in exercising the appointment power would be mindful of the need to maintain a broad and balanced representation of the public interests and the interest of the investing public in the board. As stated above, the appointees by the Financial Secretary would be drawn from the members of the community capable of representing the public interest as well as market professionals.

Paragraph 71 of Schedule 2 – Composition of the Financial Services Functional Constituency

25. Please refer to paragraphs 11 to 14 above.

Transfer of trading rights

26. Please refer to paragraphs 1 to 3 above.

Transitional arrangements

27. The risk management function of the two exchanges and the clearing houses would continue as usual during the transitional period between now and the coming into effect of the merger. As explained to the market and the industry in the earlier stage of the merger reform process, the current investor compensation schemes provided for under the Securities Ordinance and the Commodities Trading Ordinance would not be affected by the merger reform, save for modifications necessary to reflect the removal of the shareholder/membership structure. These amendments have been incorporated into the consequential amendments under Schedule 2 of the Bill. In the longer term, a new investor compensation scheme based on the consultation paper published by the SFC in September 1998 will be introduced under the composite Securities and Futures Bill. In the meantime, the SFC, the HKEC and the two exchanges are discussing the details of the new scheme.

IV. Hong Kong Society of Accountants

28. The interest of the Society to make suggestion on the candidates for the board and committees of HKEC is noted. As replied earlier to the Society, the Administration places high value on the contributions from the relevant professions including accounting to the financial market and would bear the interest of the Society in mind in considering appointments to the HKEC.

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market in respect of the particular services provided by HKEC. For services which are already subject to adequate market competition, there would appear to be no apparent need for SFC supervision as the risk of abuse is most unlikely.

4.8 It should also be noted that with the removal of the membership structure following demutualisation of the Exchanges, the level of commission charged by traders should be a matter essentially between traders and their clients.

Risk management for the market

4.9 As noted above, risk management of the clearing unit is an important function of HKEC that will have profound implications for the rest of the financial system. To ensure that HKEC will perform such function in a prudent manner and that risk-management-related decisions will not be unduly affected by profit-related considerations, the policy-making function for the clearing unit will be entrusted to a high-power, independent governance committee within HKEC. The committee should be chaired by the Chairman of HKEC personally and comprise a majority of external board members of HKEC, including representatives of market regulators including the SFC and the Hong Kong Monetary Authority, relevant market experts and public interest representatives. The decision of the committee will prevail unless overruled by, say, a two-third majority of the Board of HKEC. On matters of fundamental importance to the risk management function, the decisions of the committee will require the consent of the SFC. The power and constitution of this committee will be spelt out clearly under the law and repeated in the constitution of HKEC.

Shareholding limit

4.10 A shareholding limit of 5% will be put down in the law to prevent control of HKEC by any individual parties or parties acting in concert. The limit can be waived by the SFC in consultation with the Financial Secretary where it can be demonstrated that an exemption is in the interest of the public and the market, such as under an equity alliance with an overseas exchange. Conditions may be attached to such exemptions where deemed appropriate. In addition, any changes in the corporate structure involving changes in the equity ownership of the HKEC's subsidiaries will require the approval of the SFC in consultation with the Financial Secretary.

HKEC as a listed company

4.11 HKEC as a listed company on its own stock market will be regulated by the SFC to avoid conflict of interest and to ensure a level playing field between HKEC and other listed companies which will be subject to the listing rules administered by HKEC.

Specific provisions applicable to HKEC

- 8 HKEC would be deemed to be an REHC by the Enabling Legislation.
- 9 The Stock Exchange would continue to enjoy its current monopoly to establish, operate and maintain a stock market in Hong Kong and such monopoly would be extended to HKEC and any subsidiary of HKEC which is recognised as an Exchange Company under the Stock Exchanges Unification Ordinance.
- 10 HKEC would be required to establish a risk management committee to formulate policies on risk management matters for the markets in securities and commodities and for clearing houses. The chairman of HKEC would be the chairman of the risk management committee. The Financial Secretary of Hong Kong and the HKEC Board may appoint persons as members of the risk management committee. The decisions of the risk management committee could only be overruled by a two thirds majority of the HKEC Board.
- 11 The Financial Secretary of Hong Kong may appoint not more than eight directors to the HKEC Board to represent the interests of the public. The HKEC Directors so appointed can only be removed by the Financial Secretary of Hong Kong.
- 12 Appropriate provision would be made for the SFC to supervise HKEC's compliance with the Stock Exchange's listing rules in relation to HKEC's own listing.
- 13 HKEC would be deemed to be a public body for the purposes of the Prevention of Bribery Ordinance (Chapter 201 of the Laws of Hong Kong).

Conversion of HKSCC to a company limited by shares

- 14 HKSCC would be converted from a company limited by guarantee to a company limited by shares and become a wholly owned subsidiary of HKEC (without the need for HKEC to pay any consideration for this purpose). The guarantees given by the existing guarantors would be released.