Reforming HK Markets – the Political Realities

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25th May, 2011

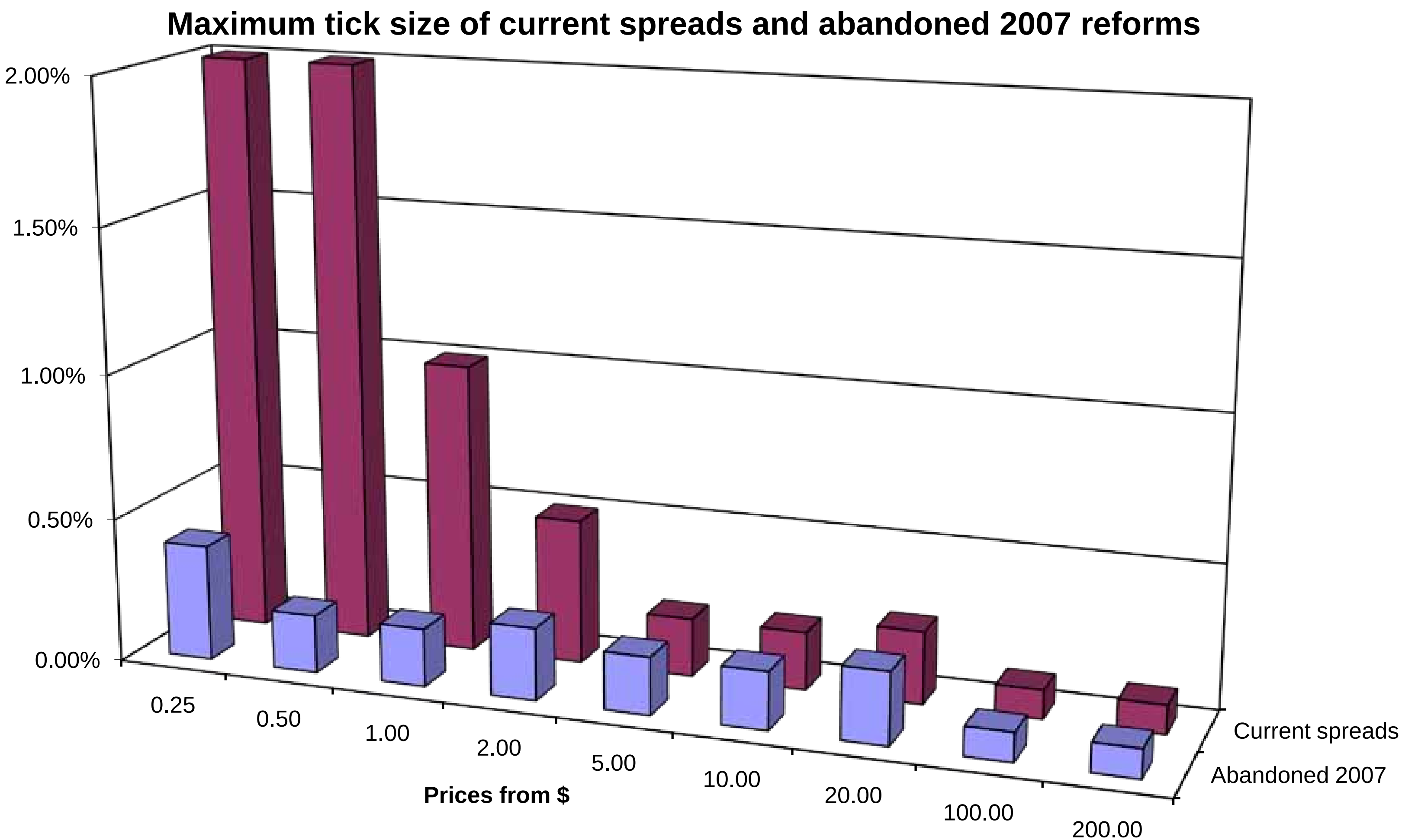
Political background

- 800-member Election Committee chose HK chief executive (1200 in 2012)
- 60-seat legislature: 30 elected directly, 30 “functional” (2012: 40 direct, 30 functional)
- Brokerage firms elect 12 (18) EC members plus the “financial services” legislator (who has a criminal record). Small brokers with less than 10% of market volume between them far outnumber the others
- If you are an individual licensed by the SFC, you are trusted with other people’s money but have no vote in the LegCo or EC elections
- Banks elect 12 (18) EC members and the “finance” legislator (currently David Li, former Dow Jones director)
- Insurers elect 12 (18) EC members and the “insurance” legislator
- Govt tends to favour interests of functional constituencies for political reasons, rather than making reforms in the public interest
- Beijing hates to see public protests, for fear of Jasmine effect
- Government appoints a majority of the HKEx board (including several cabinet members) and all the directors of the SFC. It also owns about 6% of HKEx bought by HKMA

Competition

- HKEx (0388) owns SEHK, HKFE and their clearing houses
- 4 Exchanges in HK until 1986 – running on blackboards
- Since 1986 SEHK has a statutory monopoly, the other businesses of HKEx are *de facto* monopolies
- Government has tabled a proposed competition law
- Chief Executive of HK can exempt any agreement or conduct by a person for “exceptional and compelling reasons of public policy”. HKEx, which had an 84% pre-tax profit margin in 2010, is believed to be lobbying for exemption
- If alternative trading systems (ATS) are to have a level playing field, then HKEx should not be exempt, and the statutory monopoly of SEHK should be removed.
- HK needs competition to reduce transaction costs, increase efficiency
- SFC could establish consolidated quote and reporting system (CQRS) to reduce fragmentation of liquidity and data. Operation could be outsourced
- Clearing houses should interconnect

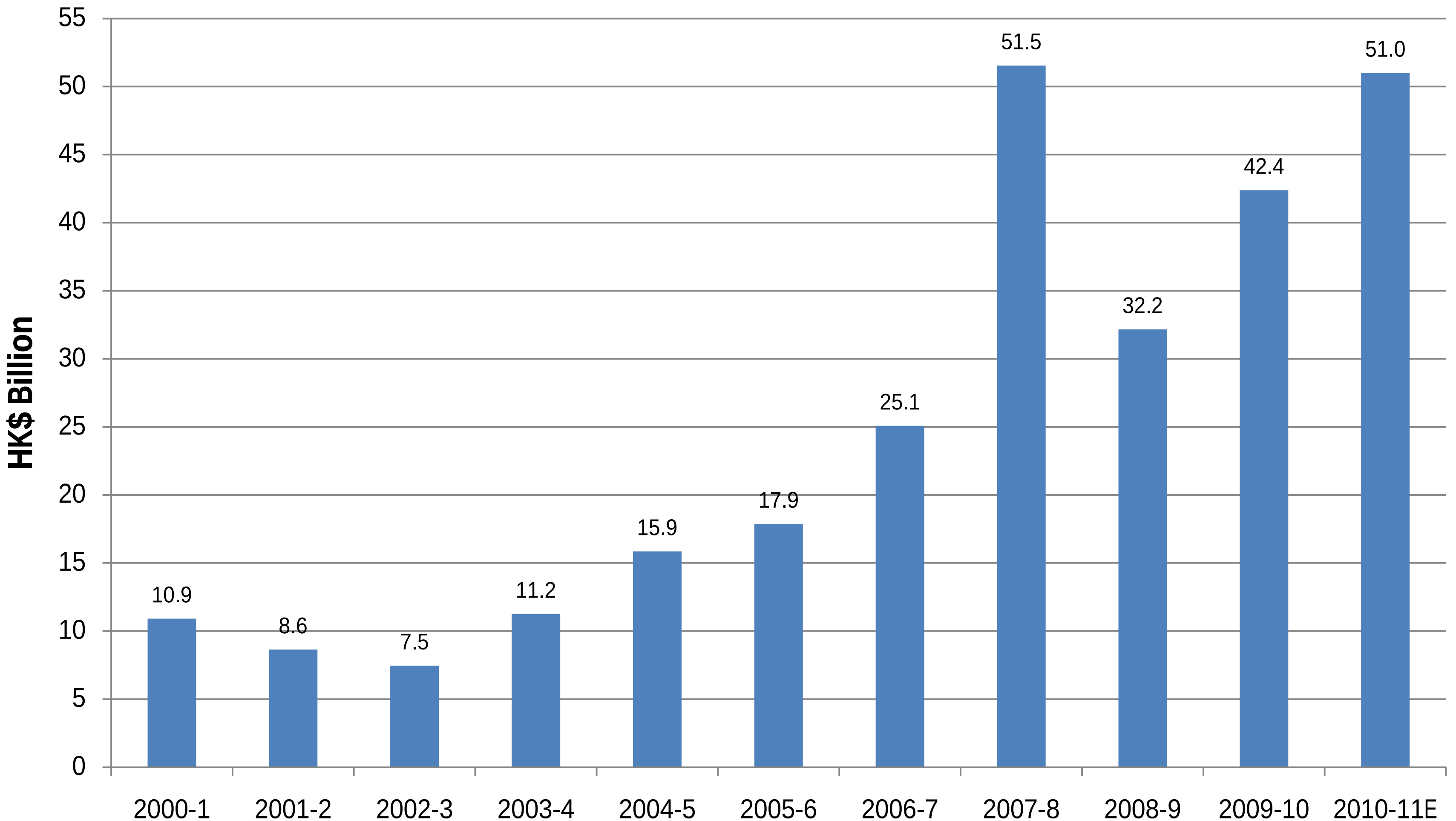
Trading spreads – unfinished business



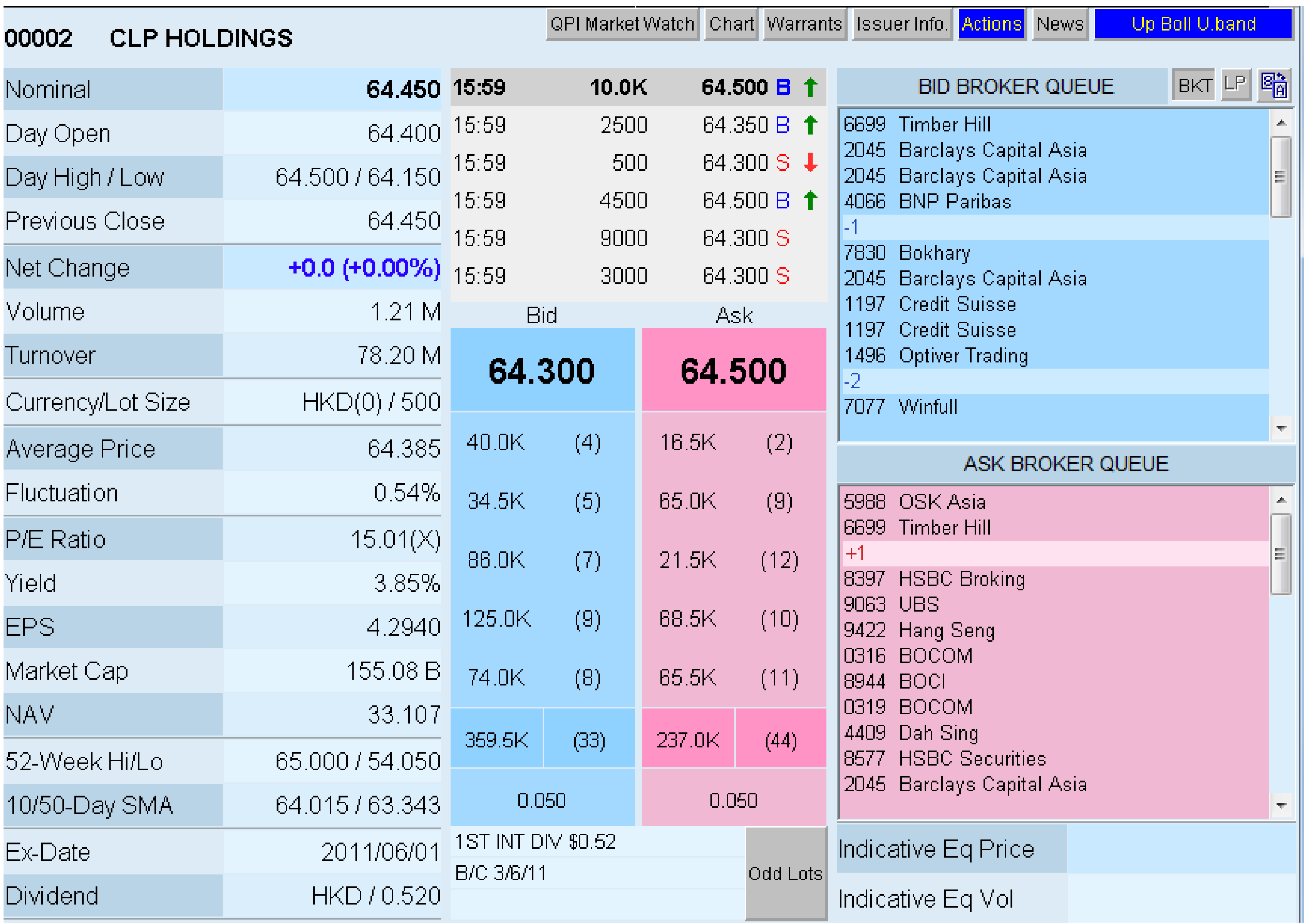
Stamp duty

- 0.1% on each side of a trade
- Only applies to equities, not warrants, CBBCs – so this incentivises speculative retail behaviour
- Impediment to higher frequency trading, pair trading, index arbitrage etc.
- Stamp duty is a frictional tax, not based on GDP, and for that reason alone should be abolished, both in stocks and real estate
- Government is going the other way – raised stamp duty on real estate over $20m to 4.25%
- Pending proposal to charge additional 15%/10%/5% on residential resales within 6/12/24 months on grounds that they are "speculative"
- Indicates government belief that speculation is evil, and a failure to understand that liquidity is the key to successful markets
- "The duty is a good regulatory tool as it adds to the costs for short-term speculators such as high-frequency traders. That is good for Hong Kong as that's not the kind of trade we want to attract" – K C Chan, Secretary for Financial Services (SCMP, 13-Dec-2010)

HK's stamp duty addiction



Broker anonymity



Broker anonymity v disclosure: issues

- If there is any signal value in broker identity, then shouldn't investors be free to exploit it?
- Large brokers benefit from "flow" knowledge; broker identity tends to offset that advantage – if they are anonymised, they may increase market share and inside advantage
- In small/mid caps, identity of broker can be a tell-tale sign of director/controller activity
- But anonymity may allow for more direct market participation – larger asset managers may just become direct exchange participants
- Who needs brokers anyway? Be careful what you wish for!

Trading hours

- Still out to lunch...
- But trading hours expanded from 4 to 5 hours on 7-Mar-2011 with 90 minute lunch break
- Expected extension to 5.5 hours on 12-Mar-2012 with 60 minute lunch hour (unless small brokers stop it)
- Small brokers opposed because of needing staff to handle customers during lunchtime
- Larger banks and brokers are happy. Retail investors can now trade during their lunch break rather than during their work hours
- Staying open during lunch hour wasn't even an option in the consultation paper
- If we had competing exchanges in HK, this would be a non-issue. We don't have a siesta in other sectors.

Closing auction

- Suspended on 23-Mar-2009, during height of global financial crisis
- Before suspending it, HKEx had proposed whacky price controls – that the closing auction could not deviate from 4pm price by more than 2% - so of course, if you want to manipulate the closing price, you do it before 4pm
- HKEx refused to consider random closing time on each stock to increase cost of manipulation
- HKEx will likely revisit this issue, so make your views known!

Thank you. Any questions?