

Reforming HK Markets – the Political Realities

David M. Webb
Webb-site.com
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Political background

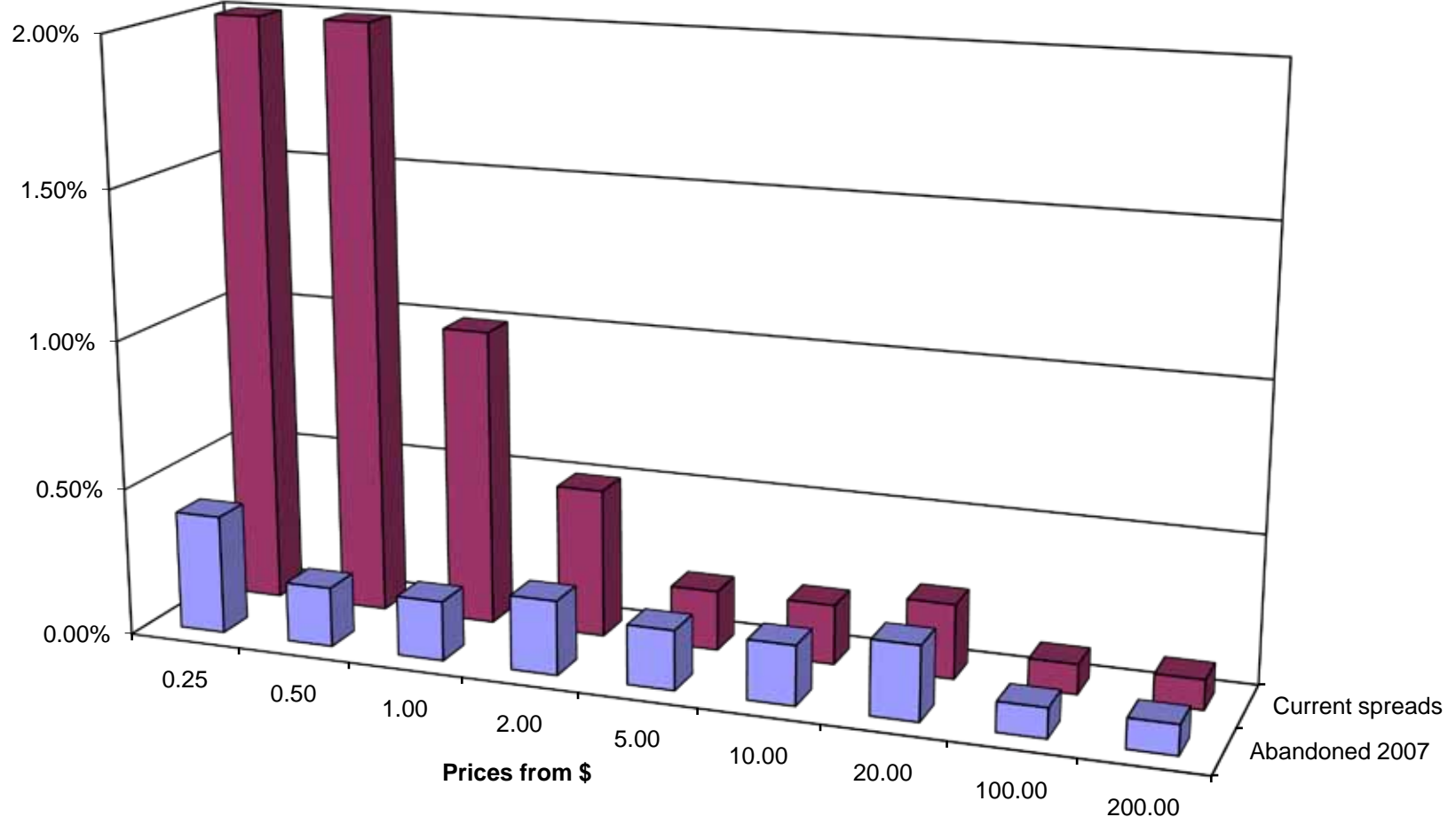
- 800-member Election Committee chose HK chief executive (1200 in 2012)
- 60-seat legislature: 30 elected directly, 30 “functional” (2012: 40 direct, 30 functional)
- Brokerage firms elect 12 (18) EC members plus the “financial services” legislator (who has a criminal record). Small brokers with less 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

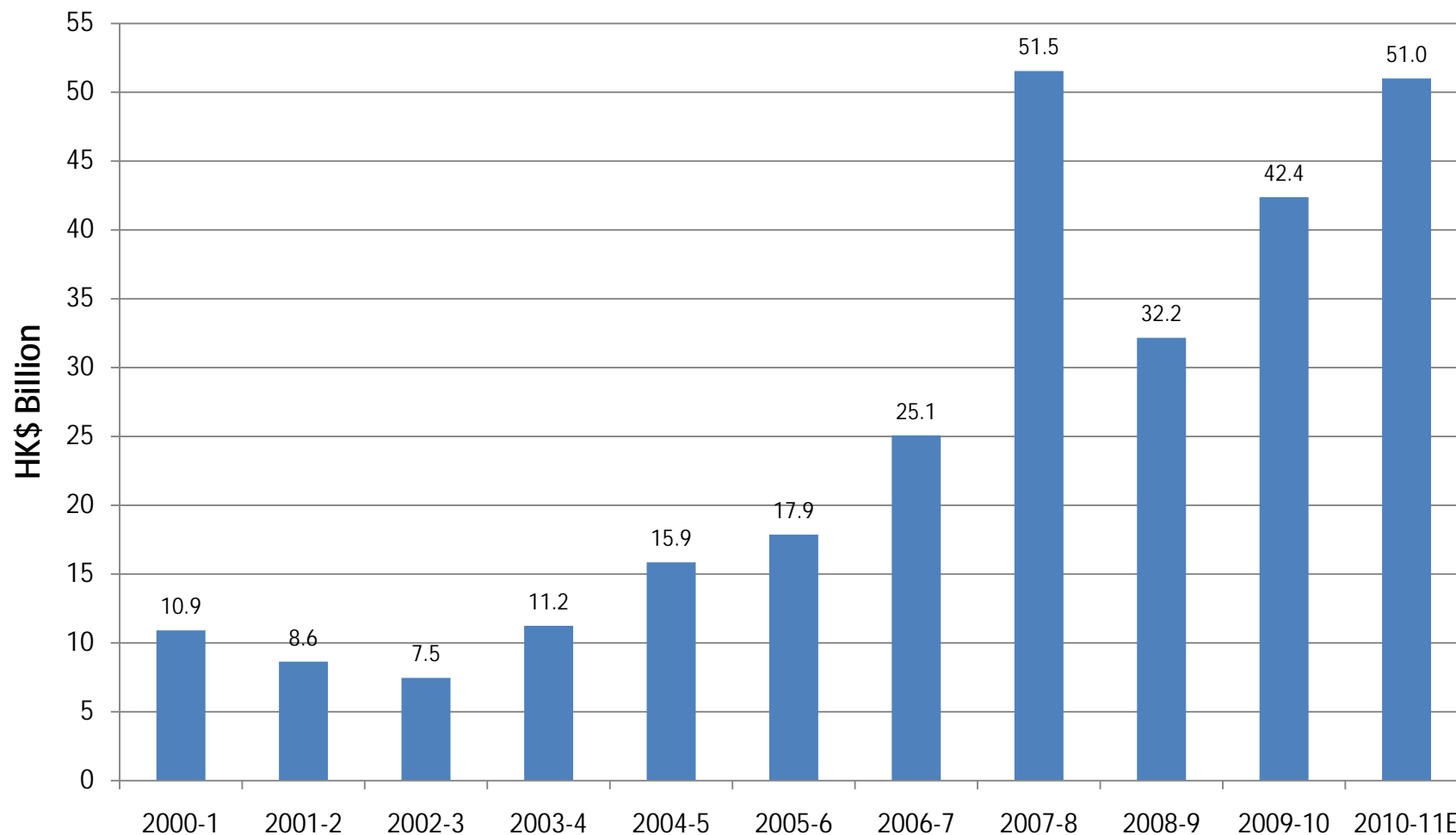
Maximum tick size of current spreads and abandoned 2007 reforms



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

00002 CLP HOLDINGS		QPI Market Watch		Chart	Warrants	Issuer Info.	Actions	News	Up Boll U band
Nominal	64.450	15:59	10.0K	64.500	B	↑	BID BROKER QUEUE		
Day Open	64.400	15:59	2500	64.350	B	↑	6699 Timber Hill		
Day High / Low	64.500 / 64.150	15:59	500	64.300	S	↓	2045 Barclays Capital Asia		
Previous Close	64.450	15:59	4500	64.500	B	↑	2045 Barclays Capital Asia		
Net Change	+0.0 (+0.00%)	15:59	9000	64.300	S		4066 BNP Paribas		
Volume	1.21 M	15:59	3000	64.300	S		-1		
Turnover	78.20 M	Bid		Ask		7830 Bokhary			
Currency/Lot Size	HKD(0) / 500	64.300		64.500		2045 Barclays Capital Asia			
Average Price	64.385	40.0K	(4)	18.5K	(2)	1197 Credit Suisse			
Fluctuation	0.54%	34.5K	(5)	65.0K	(9)	1197 Credit Suisse			
P/E Ratio	15.01(X)	86.0K	(7)	21.5K	(12)	1496 Optiver Trading			
Yield	3.85%	125.0K	(9)	68.5K	(10)	-2			
EPS	4.2940	74.0K	(8)	85.5K	(11)	7077 Winfull			
Market Cap	155.08 B	359.5K	(33)	237.0K	(44)	ASK BROKER QUEUE			
NAV	33.107	0.050		0.050		5988 OSK Asia			
52-Week Hi/Lo	65.000 / 54.050	0.050		0.050		6699 Timber Hill			
10/50-Day SMA	64.015 / 63.343	0.050		0.050		+1			
Ex-Date	2011/06/01	1ST INT DIV \$0.52		Odd Lots		8397 HSBC Broking			
Dividend	HKD / 0.520	B/C 3/6/11		Odd Lots		9063 UBS			
						9422 Hang Seng			
						0316 BOCOM			
						8944 BOCI			
						0319 BOCOM			
						4409 Dah Sing			
						8577 HSBC Securities			
						2045 Barclays Capital Asia			
						Indicative Eq Price			
						Indicative Eq Vol			

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?

