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HKEx to Implement Volatility Control Mechanism Enhancements on 11 May 2020

The Hong Kong Stock Exchange (**HKEx**) will implement Phase 1 enhancements of the Volatility Control Mechanism (**VCM**) on 11 May 2020, according to a [press release](https://www.hkex.com.hk/News/News-Release/2020/200423news?sc_lang=en) issued on 23 April 2020.

First introduced in 2016, HKEx’s VCM aims to prevent extreme volatility in stock prices. The Phase 1 enhancements include:

* expanding VCM stock coverage from Hang Seng Index and Hang Seng China Enterprises Index stocks (78 stocks) to include constituent stocks of the Hang Seng Composite LargeCap, MidCap and SmallCap Indexes (almost another 500 stocks in total); and
* applying a tiered structure of triggering thresholds ±10%, ±15%, and ±20% to the last traded price five minutes ago respectively for the constituent stocks of the three Hang Seng Composite Indexes.

Phase 2 enhancements are set to follow a review of market operations six months after the implementation of Phase 1.

1. **HKEx Volatility Control Mechanism**
* HKEx’s VCM was introduced with substantial market support following a consultation process which saw the issue of [HKEx’s Consultation Paper on the proposed introduction of a VCM in the securities and derivatives market and a Closing Auction Session (**CAS**) in the securities market in Hong Kong](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2011-to-2015/January-2015-Consultation-Paper/Consultation-paper/cp201501.pdf) in January 2015, followed by the [Consultation Conclusions](https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-%28VCM%29/cp201501cc.pdf?la=en) in July 2015.
* The proposed VCM (and CAS) model were then further enhanced in light of responses, with the main fine tunings to VCM including:
	+ Reducing the maximum number of VCM triggers from the proposed 2 per trading sessions to 1; and
	+ Excluding VCM from the first 15 minutes of the morning and afternoon trading session and the last 15 minutes of the afternoon trading session.
* Please see [Charltons’ March 2015](https://www.charltonslaw.com/hkex-consults-on-volatility-control-mechanism-and-closing-auction-session-2015/) and the [October 2015](https://www.charltonslaw.com/hong-kong-stock-exchange-publishes-consultation-conclusions-on-volatility-control-mechanism-and-closing-auction-session/) Newsletters for an overview of the January 2015 Consultation Paper and July 2015 Consultation Conclusions respectively.
1. **Hong Kong Volatility Control Mechanism**
* VCM, first introduced to the securities market on 22 August 2016 and the derivatives market on 16 January 2017, is designed to prevent extreme price volatility arising from trading incidents and to safeguard market integrity by triggering a cooling-off period where abrupt price volatility is detected.[[1]](#_ftn1)
* VCM is triggered if a stock is ± 10% (± 5% for derivatives) away from the last traded price five minutes ago. A five minute cooling-off period then commences during which trading is allowed within a fixed price band and normal trading resumes after the cooling-off period.[[2]](#_ftn2)
	1. **HKEx VCM Pre-Enhancements**
	+ The current VCM is a light-touch, simple model with limited coverage, as favoured by market participants in the 2015 Consultation.
	+ For the securities market, VCM covers HSI and HSCEI constituent stocks (a 61% market capitalisation coverage and 66% equity turnover coverage). As for derivatives, VCM covers HSI Futures (**HSI**), Mini-HSI Futures (**MHI**), H-shares Index Futures (**HHI**) and Mini H-shares Index Futures (**MCH**) spot and next calendar month contracts.[[3]](#_ftn3)
	+ VCM monitoring is applicable to continuous trading sessions (**CTS**), excluding:
		- The first 15 minutes of the morning and afternoon trading session;
		- The last 20 minutes of the afternoon trading session; and
		- The After-Hours Futures Trading session in the derivatives market.[[4]](#_ftn4)
	+ VCM is limited to one trigger per trading session (i.e. maximum of two triggers per day). Following the cooling-off period, trading resumes with no VCM monitoring within the same CTS session.[[5]](#_ftn5)
	1. **HKEx VCM Enhancements**
	+ Following guidance issued by the International Organisation of Securities Commissions (**IOSC**) [August 2018 Report on Volatility Controls](https://www.iosco.org/library/pubdocs/pdf/IOSCOPD607.pdf), HKEx, in conjunction with the Securities and Futures Commission (**SFC**), proposed enhancements to the Volatility Control Mechanism in its [August 2019 Consultation Paper](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/August-2019-Consultation-Paper-on-Market-Microstructure-Enhancements/Consultation-Paper/cp201908.pdf).
	+ The [Consultation Conclusions](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/August-2019-Consultation-Paper-on-Market-Microstructure-Enhancements/Conclusions-%28Dec-2019%29/cp201908cc.pdf) were then released in December 2019 indicating substantial market support for the proposed enhancements and outlined the two-phased approach.
	+ Phase 1
	+ As noted, Phase 1 enhancements are set to be implemented on 11 May 2020 and will comprise of the following:
		- Expanding VCM stock coverage to all HSCI constituent stocks (nearly 500); and
		- Applying a tiered structure of triggering thresholds for the constituent stocks (± 10%, ± 15% and ± 20% to last traded price five minutes ago for Hang Seng Composite LargeCap, MidCap and SmallCap Indexes, respectively.
	+ The applicable trigger threshold of each VCM stock will be published on the HKEx website, with a view to including the information in the Security Master Attribute File in the long run.
	+ The majority of corporate and individual respondents supported the proposal to expand the coverage of the Volatility Control Mechanism (70% and 89% respectively). Some respondents supported expanding VCM to all equities, however HKEx determined that given the VCM has never been triggered, the original proposal to expand to HSCI constituent stocks would remain, although the scope may be reviewed in the future.
	+ As for the tiered structure of triggering thresholds, the majority of corporate and individual respondents supported the proposal (85% and 79%, respectively), with only a few industry associations and corporate respondents representing the retail sector proposing a uniform threshold for all stocks or larger thresholds for some proposed tiers. HKEx retained the original enhancement noting the aim to strike a good balance between market protection and levels of trading interruption.
	+ Phase 2
	+ Phase 2 enhancements are subject to HKEx’s review of market operations six months following the implementation of Phase 1 enhancements. Phase 2 is set to include the implementation of multiple triggers.[[6]](#_ftn6) The implementation timeline will be announced following review.
	+ Accordingly, VCM monitoring will resume immediately following the 5 minute cooling-off period and the reference price for VCM monitoring will be the first automated trade concluded in the cooling-off period.[[7]](#_ftn7) If there is no automatched trade concluded during the cooling-off period, the first automatched trade concluded after the cooling-off period will be the reference price.[[8]](#_ftn8) This compares to presently where the reference price is determined by the last automatched price 5 minutes previously.
	+ There was general support for allowing multiple triggers in the consultation, however some market participants representing retail interests showed preference for keeping one trigger per session. This was the rationale for a two-phased implementation approach, which is aimed at ensuring a smooth transition to multiple triggers.

[[1]](#_ftnref1) [https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-(VCM)/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-%28VCM%29/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en)

[[2]](#_ftnref2) [https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-(VCM)/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-%28VCM%29/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en)

[[3]](#_ftnref3) <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Securities/Overview/Trading-Mechanism/POS-and-VCM-Enhancement-Initiatives/Market-Mircostrucutre-Enhancement-in-Securities-Market_en.pdf?la=en>

[[4]](#_ftnref4) [https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-(VCM)/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Derivatives/Trading-Mechanism/Volatility-Control-Mechanism-%28VCM%29/VCM-CAS-Web-Corner-FAQ-ENG.pdf?la=en)

[[5]](#_ftnref5) <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Securities/Overview/Trading-Mechanism/POS-and-VCM-Enhancement-Initiatives/Market-Mircostrucutre-Enhancement-in-Securities-Market_en.pdf?la=en>

[[6]](#_ftnref6) <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Securities/Overview/Trading-Mechanism/POS-and-VCM-Enhancement-Initiatives/Market-Mircostrucutre-Enhancement-in-Securities-Market_en.pdf?la=en>

[[7]](#_ftnref7) <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Securities/Overview/Trading-Mechanism/POS-and-VCM-Enhancement-Initiatives/Market-Mircostrucutre-Enhancement-in-Securities-Market_en.pdf?la=en>

[[8]](#_ftnref8) <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Trading/Securities/Overview/Trading-Mechanism/POS-and-VCM-Enhancement-Initiatives/Market-Mircostrucutre-Enhancement-in-Securities-Market_en.pdf?la=en>

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