CHARLTONS
SOLICITORS

HONG KONG STOCK EXCHANGE PUBLISHES CONSULTATION CONCLUSIONS ON VOLATILITY CONTROL MECHANISM AND CLOSING AUCTION SESSION

Hong Kong Exchanges and Clearing Limited (**HKEx**) has published its Consultation Conclusions[1] on its proposals to introduce a Volatility Control Mechanism (**VCM**) in the securities and derivatives markets and a Closing Auction Session (**CAS**) in the securities market as set out in its January consultation paper (the **Consultation Paper**).

HKEx's stated aim in making the proposals is to improve the global competitiveness of the Hong Kong market. It views a VCM as necessary for containing systemic risk caused by the interconnectedness of the securities and derivatives markets, while the CAS will meet investors' need to be able to execute trades at securities' closing prices.

For a detailed overview of both initiatives' proposed features please refer to our March 2015 newsletter.[2] This newsletter will summarise the major features and amendments the HKEx made to both initiatives since the conclusion of the consultation period in April 2015.

Voluntary Control Mechanism

The Consultation Paper noted that trading via electronic means and automated algorithms are now prevalent and that markets and products have become increasingly interconnected. These changes in trading strategies and methods have increased the potential systemic risks to market integrity, as demonstrated by the "Flash Crash" incident in the US on 6 May 2010.[3]

Following a G20 2010 review and the report of the International Organization of Securities Commissions (**IOSCO**) published in 2011, there is now an international consensus that regulators should ensure that suitable VCMs are in place to deal with volatile market situations.

Current Situation in Hong Kong

Currently, Hong Kong is one of the few jurisdictions with no VCM in place since it is a single market in which inter-venue and arbitrage trading do not take place. Stamp duty in the securities market also makes marginal arbitrage trades unprofitable. Major trading incidents like the Flash Crash have not occurred in the Hong Kong market as yet.

The Securities and Futures Commission (**SFC**) however agrees with the HKEx that Hong Kong should review whether a form of VCM is necessary to safeguard against market disorderliness caused by extreme price volatility. Given the circumstances

---

1   The Hong Kong Stock Exchange's "Consultation Conclusions: Proposal for Introduction of Volatility Control Mechanism in the Securities and Derivatives Markets and Closing Auction Session in the Securities Market" of July 2015 available at http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201501cc.pdf
2   Charltons "Hong Kong Stock Exchange Consults on Volatility Control Mechanism and Closing Auction Session" available at http://www.charltonslaw.com/hkex-consults-on-volatility-control-mechanism-and-closing-auction-session-2015/

3   Extreme price fluctuation originated from individual instruments triggered an adverse chain reaction in interconnected asset class and products and led to non-fundamental driven volatility in the overall market.

of the Hong Kong market, the HKEx views a light-touch and simple VCM regime to be the most appropriate as it is a new mechanism for the market, although a more sophisticated system could be implemented if needed in the future.

Features of VCM (to be implemented)

Features that were amended after the Consultation Paper are marked as "(amended)".

- *Type of VCM*: dynamic price limit model applied at the individual instrument level to capture rapid price changes.

- *Applicable instrument types*: Hang Seng Index and Hang Seng China Enterprise Index constituent stocks in the securities market and H-shares Index, Mini-Hang Seng Index & Mini H-shares Index (spot and next calendar month) futures in the derivatives market.

- *Applicable trading session* (amended): the VCM will only apply during the Continuous Trading Session (**CTS**) (i.e. excluding the auctions sessions for both markets and the After-Hours Futures Trading session in the derivatives market). There will be a 15-minute uninterrupted trading period before the end of the afternoon CTS to allow investors to unwind their day positions and avoid taking overnight risks. In addition, the VCM will not apply for the first 15 minutes of the morning and afternoon CTS to allow for free price discovery at the market open.

- *Reference price*: a dynamic reference price being the price of the last trade 5 minutes ago.

- *Triggering Level*: a price limit of ±10% from the reference price for the securities market and a price limit of ±5% from the reference price for the derivatives market.

- *Number of VCM triggers* (amended): in the Consultation Paper, a maximum of 2 VCM triggers per instrument for each trading session (morning and afternoon sessions are 2 separate trading sessions) was proposed to minimise market interruption. However, the Consultation Conclusions has amended this feature so that there will be a maximum of one trigger per instrument for each trading session (2 sessions per day, so a maximum of two triggers per trading day). Over time, multiple triggers might be considered. There will be no further VCM monitoring after a cooling-off period for the remainder of that trading session. However, if the

maximum number of triggers per instrument is increased to more than one in future, VCM monitoring will resume after the cooling-off period.

- *Cooling-off period*: order execution of each instrument will be monitored against the dynamic price limit of ±10% for securities (± 5% for derivatives) from the last trade price 5 minutes ago. A potential execution price beyond the dynamic price limit will be rejected and trigger a 5-minute cooling-off period during which the instrument can trade only within the price limit immediately before the VCM trigger. Bids above or below the price limit during the cooling-off period will be rejected.

- *Market Data Dissemination*: once the VCM is triggered, the reference price, upper and lower price limit, trading state and time of VCM expiry/resumption would be distributed through the market data feed to enable market participants to make informed choices. The VCM instrument would also be flagged in the market data feed.

- *Inter-market/product connectivity*: all instruments would be treated independently for the purposes of the VCM. The trading of related instruments (e.g. futures contracts of different contract months) on the same underlying and derivatives would therefore remain unaffected when a VCM is triggered for the underlying / applicable contract. As at present, market makers or liquidity providers will still be able to make markets for the related instruments in these circumstances, although they will be able to request a waiver or relaxation of their market making obligations.

Closing Auction Session

The CAS was implemented for a period of 9 months in 2008. The new CAS to be introduced is the reinstatement of an improved CAS in order to enable orders at the closing price.

In the securities markets of developed countries, continuous trading (or continuous auction) and single-price auction (or call auction) are the main types of trading mechanisms that are commonly adopted. In short, continuous trading occurs when bid and ask orders are submitted to the market and executed in price and time priority against matching orders within a central limit order book; while the usage of single-price auction takes place at day open, day close, or after a prolonged period of non-trading, and involves bid and ask orders being pooled in a call phase and executed at a single price at which most can be matched. Additionally, a third trading mechanism, closing auction session, is commonly adopted by all securities

exchanges in developed countries except Hong Kong. In short, this mechanism accommodates the need to execute orders at the closing price; index tracking funds in particular are required to rebalance their holdings at the closing price when tracking their underlying index and for fund valuation purposes.

Features of CAS (to be implemented)

Features that were amended after the Consultation Paper will be marked as "(amended)".

• Applicable securities and rollout phase:

Phase I (amended): CAS is applicable to Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap index constituents as well as other H shares which have corresponding A shares listed on the exchanges in Mainland China. Additionally, in the Consultation Paper, HKEx proposed that CAS applicability to ETFs should be limited to ETFs with underlying Hong Kong stocks; however, in the Consultation Conclusions, HKEx has now permitted the CAS to apply to all ETFs.

Phase 2: CAS would apply to all other equity securities and funds except for structured products, equity warrants and debt securities. However, this phase would only be implemented 6 months after initial launch and following a review (not a separate consultation) of Phase 1 to confirm the rollout of Phase 2.

• *Price Limit*: to prevent excessive CAS price volatility, initially, a price limit of ± 5% from a reference price will be imposed on at-auction limit order entry during the Order Input Period. To facilitate price discovery through at-auction limit orders while maintaining the maximum possible range of executable prices in the Order Input Period, a further price limit between the prices of best bid and best ask during the No-Cancellation and Random Closing Periods will be imposed.

• *At-auction limit orders*: to facilitate better price discovery, the input of at-auction limit orders throughout the CAS is permissible initially at ±5% from a reference price and later at the prices of best bid and best ask (refer to the above paragraph).

• *Short Selling* (amended): in Phase 1, short selling is prohibited. In phase 2, the HKEx will consider rolling out short selling subject to a tick rule on the reference price (at or higher than the reference price) to facilitate better price discovery.

• *Order amendment & cancellation*: to encourage market participants to input orders before the No-Cancellation period and to prevent drastic changes to the order book towards the end of the CAS, HKEx will prohibit order amendment and cancellation during the No-Cancellation and Random Closing Periods.

• *Random Closing*: to discourage gaming around closing time and to encourage the early input of orders, a 2-minute random closing period of the CAS will be decided by the system. This will be followed by order matching of all CAS securities.

• *Trade Matching in absence of Indicative Equilibrium Price (IEP)*: IEP is the indicative auction price for matching at any time during the auction process as if the auction is concluded then. Generally, it is the price within the highest bid and the lowest ask and at which the aggregate volume of matchable orders is maximised. In the absence of a final IEP, the Reference Price will be used for trade execution.

• *CAS duration* (amended): on the issue of CAS duration, the Consultation Paper proposed either a 7-minute or 5-minute Order Input Period. HKEx has decided to adopt a 5-minute Order Input Period so that the CAS will end at 4:10 p.m (16:10).

• *Trading Hours of the Derivatives market* (changed): when the CAS is introduced, the close of the derivatives market's afternoon session for Stock Index Futures, Stock Index Options, Dividend Futures, HSI Volatility Index Futures and CES China 120 Index Futures will be extended by 15 minutes to 4:30 p.m. (16:30). In order to maintain a 45-minute break, the start of After-Hours Futures Trading will be postponed to 5:15 p.m. (17:15).

Implementation Timelines

The VCM and CAS will be implemented on the current trading platforms, namely the AMS/3.8 in the securities market and HKATS in the derivatives market. To minimise migration risk and development and testing efforts, the VCM and CAS will be developed and tested together, but implemented in phases (CAS Phase 1 first and then the VCM). Approximately one

year preparation lead time will be given to the market. For the securities market, the phased rollout of the CAS (as described above) and then the VCM is tentatively scheduled to start from the third quarter of 2016. For the derivatives market, the rollout of the VCM is tentatively scheduled for the last quarter of 2016. HKEx will publish more implementation details in due course.

Respondents to the consultation indicated that the CAS and VCM should have priority over the implementation of trading halts. HKEx plans to introduce trading halts to allow inside information to be disseminated during trading hours. Trading halts will be introduced as part of the Orion Trading Platform-Cash infrastructure which is tentatively scheduled to be implemented in 2017 or later.

CHARLTONS

Hong Kong Office
Dominion Centre
12th Floor
43-59 Queen's Road East
Hong Kong
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596

www.charltonslaw.com