

TOPIC 5 - OVERVIEW

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1. TRADING SYSTEM IN HONG KONG

- All securities traded on the SEHK must be executed/concluded through the Orion Trading Platform – Securities Market (OTP-C)
- OTP-C is only accessible to Exchange Participants

1.1 Orion Trading Platform – Securities Market

- OTP-C offers a scalable, flexible and high performing cash equity trading platform based on open systems technology
- OTP-C was introduced in February 2018 to replace AMS/3, the third generation of Automatic Order Matching and Execution System, launched in October 2000
- When placing an order, the investor must provide:
 - An account number
 - Stock name and code
 - Quantity to be bought/sold and the price limit
- Orders are placed with an EP via telephone, mobile or internet

1.2 Trading Procedures for the Cash Market

- A pre-opening session runs from 9.00am to 9.30am when pre-open trades are input to the system
- The continuous trading session starts at 9.30am and runs until 4.00pm
- Orders are continuously executed in strict price and time priority
- The **closing auction session** runs from 4.00pm to 4.10pm consisting of a reference price fixing period, an order input period, a no cancellation period and a random closing period

Types of Orders

- During the pre-opening session, only “at-auction” and “at-auction limit” orders are accepted by OTP-C:
 - *At-auction order*: an order with no specified price – unfilled orders are automatically cancelled at the end of the pre-opening session
 - *At-auction limit order*: an order with a specified price – unfilled orders at the end of the pre-opening session are converted to limit orders and carried forward to the continuous trading session, provided specified price does not deviate 9 times or more from prevailing nominal price
- During the continuous trading session, orders accepted by OTP-C are:
 - *Limit order*: matching can only occur at the specified price. The sell order price cannot be below the best bid price, whereas the buy order price cannot be above the best ask price. Any unfilled orders join the price queue
 - *Enhanced limit order*: allows matching of up to 10 price queues
 - *Special limit order*: allows matching of up to 10 price queues, and there is no restriction on input price. Any unfilled orders will be cancelled

Quotation Rules

- The first order entered into OTP-C on each trading day must comply with the following:
 - If it is a bid, it must be at a price $>$ previous closing price minus 24 spreads
 - If it is an ask, it must be at a price $<$ previous closing price plus 24 spreads

Closing Price

- Calculated using the median figure of the 5 nominal prices recorded in the last minute of trading each day

Volatility Control Mechanism (VCM)

- VCM was launched by HKEx in August 2016 and is designed to safeguard market integrity from extreme price volatility resulting from flash crashes and algorithm errors
- If a stock price deviates by more than 10% from the reference price (last traded price 5 minutes ago), it will trigger a cooling-off period of five minutes
- Allows market participants to reassess their strategies covering HSI and HSCEI constituent stocks
- There is a maximum of one trigger in each trading session for each instrument to minimise market interruption

Stock Connect

- Launched in November 2014, the Shanghai-Hong Kong Stock Connect “SH-HK Stock Connect” allows eligible investors in Mainland China to trade shares listed on the SEHK, known as the **Southbound link**, and investors in Hong Kong to trade A shares listed on the Shanghai Stock Exchange (“SSE”), known as the **Northbound link**.
- Launched in December 2016, the Shenzhen-Hong Kong Stock Connect “SZ-HK Stock Connect” allows eligible investors in Mainland China to trade shares listed on the SEHK, known as the **Southbound link**, and investors in Hong Kong to trade A shares listed on the Shenzhen Stock Exchange (“SZSE”), known as the **Northbound link**.
- These links are an important step in the internationalization of Mainland China’s capital markets and currency.
- **Home market rules apply to all trades.** Orders are placed through local securities firms, however trading and clearing is subject to the rules and procedures of the exchange where the securities are listed.
- Trading and clearing participants are regulated by the rules and laws of the markets where they operate
- **All Hong Kong persons and overseas investors** able to trade on the SEHK can participate in the Northbound links
- Mainland China persons who are able to participate in the Southbound link include institutional investors and individuals with Rmb500,000 in cash and securities

- Only eligible shares may be traded through Stock Connect. **Northbound eligible** shares are:
 - SSE 180 Index constituents
 - SSE 380 Index constituents
 - SSE listed A shares with dual listing of H shares on the SEHK
 - SZSE Component Index constituents
 - SZSE Small/Mid Cap Innovation Index constituents
 - SZSE listed A shares with dual listing of H shares on the SEHK

Northbound shares that are excluded:

 - Shares trading in a currency other than the Rmb
 - Shares listed on the SSE/SZSE's risk alert board
- **Southbound eligible shares are:**
 - Hang Seng Composite Large Cap Index constituents
 - Hang Seng Composite Mid Cap Index constituents
 - Shares of all companies listed on both the SEHK and the SSE/SZSE

Southbound shares that are excluded:

 - Shares trading in a currency other than the Hong Kong dollar
 - H shares which have a corresponding listing on any Mainland exchanges besides the SSE/SZSE; and
 - H share issuers which have a corresponding A share on the SSE/SZSE's risk alert boards
- There are **daily quotas** for the value of shares traded on both the Northbound and Southbound links of SH-HK Stock Connect. The quotas are expected to be expanded as the program evolves.
- The current **Northbound trading link daily quota** is Rmb 52 billion
- The current **Southbound trading link daily quota** is Rmb 42 billion
- The daily quotas are calculated on a **“net buy” basis**
- Sell trades increase the available quota. Investors are always allowed to sell their cross-border securities. The daily quota is reset to zero at the beginning of each trading day
- Buy trades are subject to availability in the respective quotas. If the available aggregate quota is less than the daily quota, only sell trades will be permitted on that day
- Trading under both Northbound and Southbound links is through local securities firms who are exchange participants/members or have arrangements with participants to execute orders
- **Southbound executed trades** are settled on the usual T+2 basis, however **Northbound executed trades** are settled on the trade day for securities settlement and T+1 for cash settlement

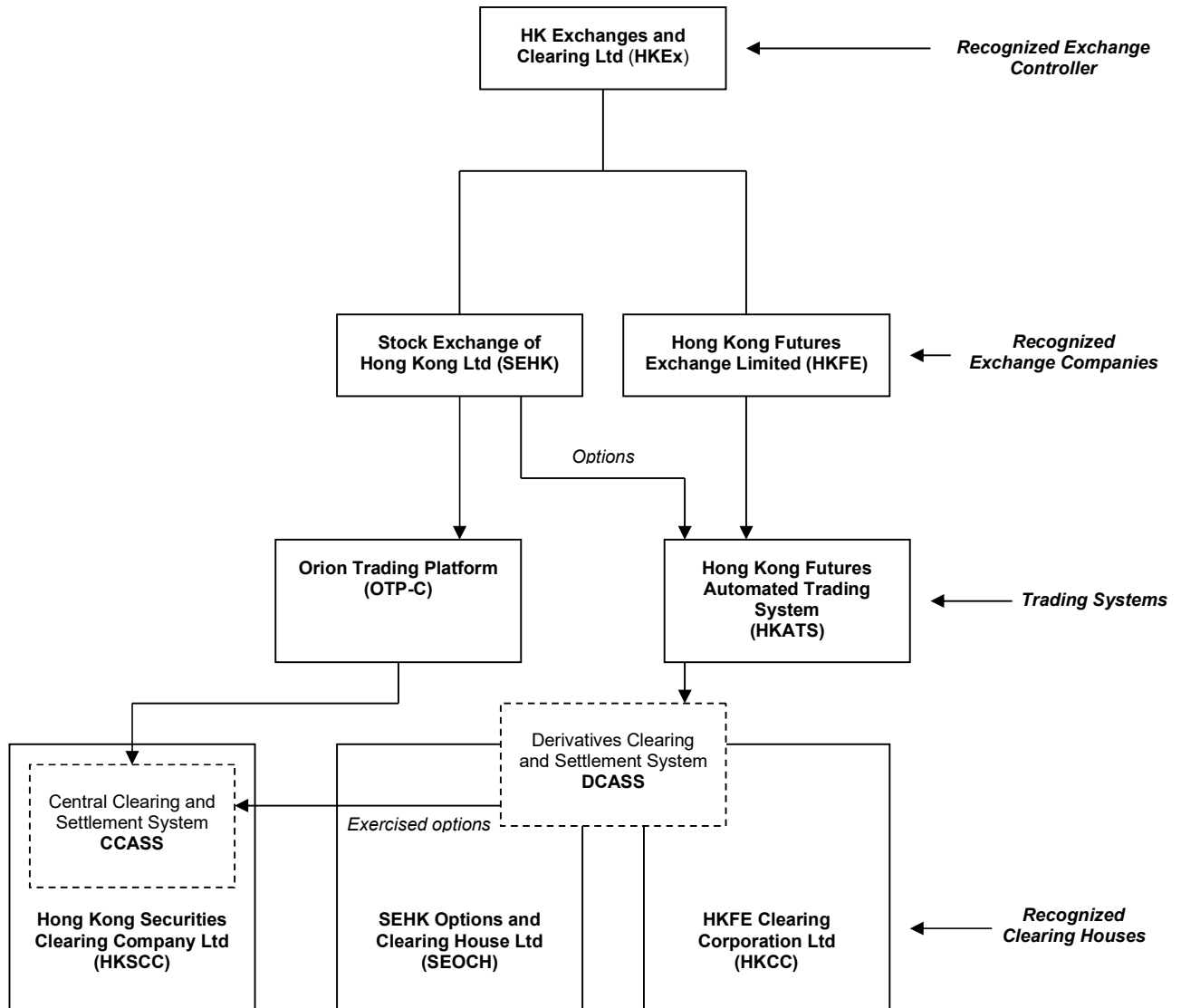
- To facilitate the Mainland exchanges' and regulator's market surveillance on Northbound orders/trades, the **investor identification model** for Northbound trading was implemented
- EPs that offer Northbound trading services must assign a unique number, known as the Broker-to-Client Assigned Number (BCAN) to each of their Northbound trading clients

1.3 Trading Mechanism for Derivatives

- HKFE Exchange Participants trade derivative products using the Hong Kong Futures Automated Trading System (HKATS)
- HKATS replaced the open outcry system in 2000

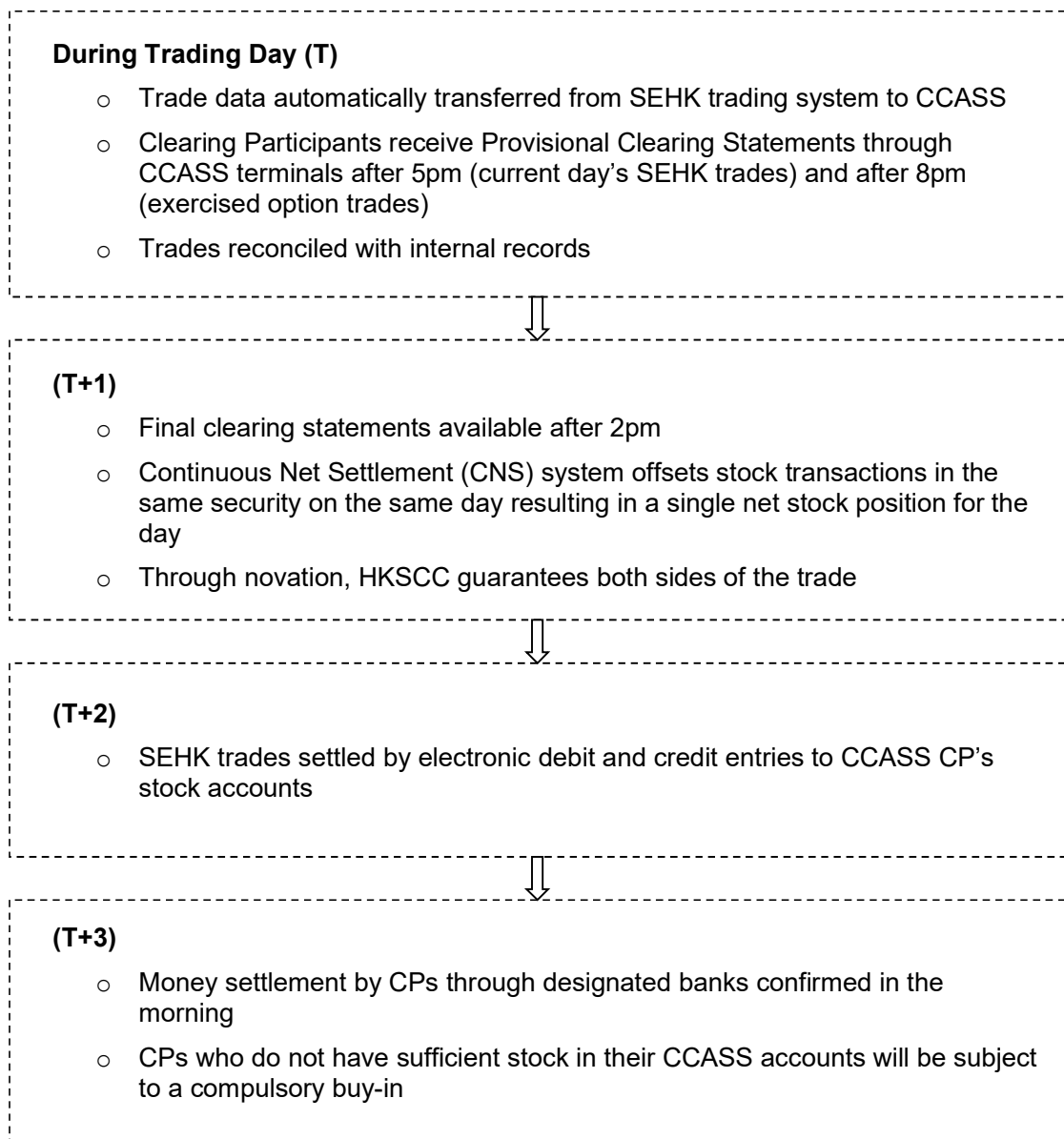
2. CLEARING AND SETTLEMENT SYSTEM IN HONG KONG

- All securities traded through the SEHK are settled through the Central Clearing and Settlement System (CCASS)
- Stock options are settled through the Derivatives Clearing and Settlement System



2.1 Clearing and Settlement

- The clearing and settlement system is as follows:



3. TRANSACTION COSTS IN STOCK TRADING

- Transaction costs associated with stock trading are payable to the brokerage house, share registrars, the SEHK and the government

3.1 Brokerage House

- No minimum
- Negotiable between brokerage house and investors

3.2 The Stock Exchange of Hong Kong Limited

Transaction Levy and Investor Compensation Levy

- Two levies charged by the SEHK on each purchase/sale of securities on behalf of SFC
- Transaction levy of 0.0027% - no levy on Securities Market Maker (SMM) transactions
- Investor compensation levy of 0.002% - suspended since 19 December 2005

Trading Fee

- 0.005% charged to both buyer and seller and paid to SEHK

Trading Tariff

- HK\$0.50 charged on each purchase/sale payable to SEHK

HKSCC Clearing and Settlement Fee

- 0.002% payable by the broker to SEHK for every purchase or sale transaction. Broker may absorb fee or pass it on to clients

3.3 The Government

Ad Valorem Stamp Duty

- 0.1% on each purchase/sale

Transfer Deed Stamp Duty

- HK\$5 charged to seller, irrespective of quantity traded

Transfer Fee

- Registrar of each listed company charges HK\$2.50 per share certificate on buyers

4. TRADING RECORDS MANAGEMENT

- SFC has issued:
 - **Code of Conduct** for Persons Licensed by or Registered with the Securities and Futures Commission
 - Management, Supervision and **Internal Control Guidelines** for Persons Licensed by or Registered with the Securities and Futures Commission
- This section considers the records and internal procedures required by the SFC when trading securities
- The Code and Guidelines **do not have the force of law**, however failure to comply may reflect adversely upon a licensed person's "fit and proper" status

4.1 Internal Control Procedures and Code of Conduct

- A securities company must have adequate internal control procedures including appropriate **segregation of duties**:
 - Sales should be independent of settlement
 - Internal audit should not be influenced by other functions
- Securities companies must have procedures for **opening accounts** that:
 - Maintain all relevant information including approvals and client agreements
 - Ensure clients receive information regarding their rights and obligations, including relevant risk disclosures
 - Ensures that KYC (Know Your Client) procedures are properly carried out
- Securities companies must have procedures for **taking orders**:
 - Standard order forms should be used for recording orders
 - Orders must be time-stamped and transmitted to dealers within a reasonable time
 - Telephone orders must be recorded and recordings must be kept for at least **six months**
 - Orders must be checked before execution ensuring status of client account, account limits, sufficient available funds, availability of securities for sell orders and authority of person placing the order
- Securities companies must have **adequate accounting and back office procedures**, including:
 - Dealing tickets must be entered into the firm's in-house system
 - Trades must be confirmed with client
 - Trade errors must be reported
 - A reliable audit trail must be maintained so that any suspected errors or irregularities can be investigated

4.2 Internal Audit

- A firm is required to have a **clear audit policy** ensuring that:
 - The internal audit function **reports directly to management** or an audit committee
 - Clear terms of reference for both internal and external audit functions are established
 - Relevant staff are adequately trained with sufficient technical knowledge
 - Audit results and findings are adequately recorded so that problems and risks are highlighted and resolved

5. CONDUCT OF BUSINESS

- The SFC's codes of conduct outline expected standards of behaviour which cover the general principles of conduct for financial practitioners, as put forward by the International Organizations of Securities Commissions (IOSCO)
- The codes provide guidance only and financial practitioners are expected to apply the codes in an ethical manner
- SFC's nine principles are:
 - Honesty and fairness
 - Diligence
 - Capabilities
 - Information about clients
 - Information for clients
 - Conflicts of interest
 - Compliance
 - Client assets
 - Responsibility of senior management

6. RISK MANAGEMENT

- Firms must have appropriate and effective risk management policies and procedures covering the following areas:
 - **Credit risk:** risk of a client or counterparty defaulting on an obligation
 - **Market risk:** risk of an intermediary suffering a loss due to adverse movements in asset/liability market values
 - **Liquidity risk:** risk that a product may not be sold in the short term without material loss
 - **Operational risk:** risk of losses from fraud, errors, omissions and other operational/compliance matters

7. TECHNOLOGY

7.1 Internet Securities Trading

- Internet trading provides investors with an **efficient and flexible means of trading**
- OTP-C allows internet trading of securities

7.2 On-line Financial Information

- Some of the largest electronic information providers (Bloomberg, Reuters and Dow Jones Newswires) allow access to their data via the internet. Some of the services provided include:
 - Access to real-time financial data
 - Analysis of financial data
 - Electronic trading and straight-through processing
 - Market services for buyers and sellers
 - News and financial information
 - Up-to-date economic data

7.3 Impact of Technology

- Technology has brought **rapid changes to the financial markets** and this is only expected to continue
- Resulting changes include:
 - Availability of vast amounts of up-to-date information to both investors and investment professionals
 - On-line securities trading
 - Faster and more efficient execution and settlement
 - Access to a global market-place
 - Prompt paperless trading
 - A wider choice of investment products for investors
- Technological advancements have enabled complex automatic trading strategies which have led to **High Frequency Trading (HFT)**
- HFT is identified by the following common features:
 - Sophisticated technological tools, both in hardware and software
 - Algorithmic and quantitative approaches
 - Executed by proprietary trading firms
 - High order and transaction daily turnover
 - Very few, if any, overnight positions held