

Part B Consultation Questions – Volatility Control Mechanism

Please indicate your preference by checking the appropriate boxes and provide reasons to support your views. Where there is insufficient space, please attach additional pages as necessary.

1. Do you support the introduction of an instrument-level VCM based on a dynamic price limit model in Hong Kong?

Yes

No

Please give reasons for your view.

While it is important that all EPs are diligent in protecting their orders from disrupting a fair and orderly market, in practice, it is extremely difficult to ensure all participants will never make such a mistake. Given the cost of such a potential disruption, having the SEHK take additional measures to assist in protecting the market is a logical and sensible conclusion. This also allows the exchange to set the bar and remove any ambiguity for what is accepted as fair price discovery.

2. Do you agree that the proposed VCM model should only be applied to the HSI and HSCEI constituent stocks in the securities market?

Yes

No

Please give reasons for your view.

While gearing the VCM model to HSI names will help protect from interdependent events disrupting the market on a larger scale, there still exist a large number of illiquid names which would benefit from such protection. These illiquid names tend to be more commonly mispriced due to sparsely populated order books which can cause large jumps in price disrupting the fair value of the asset. Looking across daily high to low returns for each index, year to date (as of March 30th, 2015), HSI 100% and HSCEI 99.6% of all names on all days had a return less 10%. Whereas outside these 2 indices, 6.8% had high to low returns greater than 10%. According to these statistics (see figure 1-3 in supplementary document), the proposed VCM will only be effective in extreme outlier events.

3. Do you agree that the proposed VCM model should only be applied to the HSI, HHI, MHI & MCH (spot month and the next calendar month) index futures in the derivatives market?

Yes

No

Please give reasons for your view.

As per our response to Q2, we believe that if a VCM is applied it should be applied consistently to all instruments.

4. Do you agree that the market should have a 15-minute uninterrupted trading period before the end of the last continuous trading?

Yes

No

Please give reasons for your view.

Have no control during the first 5 minutes and last 20 minutes leaves the market participants exposed during that time. In addition, given that the proposed CAS solution does include price controls, this may force unnecessary excessive volatility into this 15 minute period, potentially negating the intention of the CAS price controls. Increasing the bands during that period may be a more adequate solution so as to provide control yet not reduce the ability to actively trade efficiently into the close.

5. Do you agree with the proposed reference price for the securities market, namely the price of last trade 5 minutes ago? If not, what would you prefer?

Yes

No, I would prefer: A smoothed estimator which involves multiple price samples. For example, a 5 minute moving average, 5 minute vwap or other estimator. If this is too complex to implement, a static reference price is also acceptable.

Please give reasons for your view.

A single trade is a poor estimator for fair value price and likely to lead to erratic price bands. For example if 1 trade is done on the bid, and the next on the offer, the band would shift regularly in a noisy fashion and creating moment to moment jumps in the price band making tradeable prices equally erratic. Looking across Hong Kong symbols year to date broken into 5 minute buckets, we find up to 65 distinct prices up to over 5% returns in HSI names, 54 distinct prices and up 17% returns in HSCEI names and 186 distinct prices and 172% returns on other names (see figures 4-6). Picking a single price where the variance is as high as above would create a very erratic volatility band. Using a simple smoothing mechanism such as an 5 minute vwap as a baseline price would be much more appropriate from our analysis.

If left as proposed, theoretically, if paced properly, two high risk scenarios are feasible:

- 1). Trading in gradual increments under the 10% limit continuously and thus effectively realizing no limit at all.
- 2). A favorable large dislocation in price (outlier or fat finger) would disable trading at the true fair value price.

6. Do you agree with our proposed reference price for the derivatives market, namely the price of last trade 5 minutes ago? If not, what would you prefer?

Yes

No, I would prefer: A smoothed estimator which involves multiple price samples. For example, a 5 minute moving average, 5 minute vwap or other estimator. If this is too complex to implement, a static referenc price is also acceptable.

Please give reasons for your view.

See Q5 response.

7. Do you agree with the proposed triggering level for the securities market, namely 10% from the reference price across the proposed instruments covered by the VCM? If not, what level would you prefer?

Yes

No, level that I would prefer: _____

Please give reasons for your view.

As mentioned above, for HSI names, 10% would not have been triggered once in 2015. HSCEI had a few instances where the VCM would activate. If it is elected to add support for other securities, it would be advisable to take a more tiered approach to the limits, perhaps based on ticks and returns. If the intention is to catch only true outliers, the proposed settings would be acceptable and rarely, if ever activate.

8. Do you agree with the proposed triggering level for the derivatives market, namely 5% from the reference price across the proposed instruments covered by the VCM? If not, what level would you prefer?

Yes

No, level that I would prefer: _____

Please give reasons for your view.

9. Do you agree that a maximum of two VCM triggers per trading session per instrument should be imposed to minimise market interruption?

Yes

No, I would prefer: To avoid removing the VCM at any time during the continuous session.

Please give reasons for your view.

If a VCM is applied, it should apply from start to finish of the continuous sessions. Leaving holes in the protection layer would allow for potential disruption of a fair and orderly market. If the VCM is well fit to the market and stock, there should be limited or no disruption to the efficiency of the market. If the stock has already moved more than 20% despite 2 VCM activations we do not see reason to stop intervention but rather the contrary. Consistent volatility control across the entire duration of the market is an approach which is consistently found in other markets. Allowing any escape route defeats the purpose of the intended control

10. Do you support trading within a price limit during the cooling-off period? If not, do you prefer another approach?

Yes

No, another approach that I prefer: _____

Please give reasons for your view.

This is sufficient for now however we would advise following cooling off with another auction as found in many developed markets.

11. After the cooling-off period, do you support resuming the same dynamic price limit monitoring mechanism (i.e. $\pm 10\%$ ($\pm 5\%$) from the last trade 5 minutes ago in the securities (derivatives) market)? If not, do you prefer another approach?

Yes

No, I would prefer: _____

Please give reasons for your view.

The same dynamic price limit is fine, however the removal of the limit if no trade occurs during the cooling off period (point 40 of the consultation paper) opens up for potential market disruption. See point 9.

12. Do you have any other suggestions on enhancing the resumption procedures?

If there are no trades during the cooling of period, there would be no price restrictions after that. One possible scenario would be an aggressive algo order constrained by the cooling off period which could potentially move the price significantly immediately after the period ends. Using a volume weighted auction would be more advisable and inline with approaches found in many other exchanges.

13. Do you agree that the duration of the cooling-off period should be 5 minutes for both the securities and derivatives markets? If not, what would you prefer and why?

Yes

No, I would prefer: _____

Please give reasons for your view.

14. Do you agree with the additional market data dissemination for the proposed VCM model? If not, what would you propose and why?

Yes

No, I would propose: _____

Please give reasons for your view.

This is absolutely the right approach and essential for building electronic trading systems.

15. If a VCM is triggered for a given instrument, should trading of related instruments (e.g. futures contract of different contract months) on the same underlying continue as normal?

Yes

No

Please give reasons for your view.

Keeping the market opened in other months may cause these contracts prices to also become distorted

16. If a VCM is triggered for a given instrument, should trading of derivatives (e.g. single stock options or warrants) of that instrument continue as normal?

Yes

No

Please give reasons for your view.

It is not clear what trading of derivatives of an instrument (single stock options) continue as normal means. Since there is no VCM on single stock options, if VCM is triggered for a particular stock, does exchange stop trading of the corresponding single stock options if the answer is No? VCM triggered does not halt trading on the single stock.
This implies trading on single stock options will continue as normal?

17. Do you have any other comments on the VCM proposal?

Part C Consultation Questions – Closing Auction Session

18. Do you support the introduction of the new CAS model in the Hong Kong securities market?

Yes

No

Please give reasons for your view.

This is a key feature missing in the Asia market structure.

19. Do you agree that the new CAS model should only be applied to the major index constituent stocks (i.e. Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap Index constituents as well as other Stock Connect Securities for Southbound trading)?

Yes

No

Please give reasons for your view.

This should apply to all assets, there is no need for a separate mechanism this complicates and convolutes the market. If this will decrease time to market to introduce it on different segments of stocks, then a piecemeal approach would be considered.

20. Do you agree that the new CAS model should be applied to ETF? If yes, which type of ETF should be applied?

Yes

(i) Apply to all ETFs

(ii) Only apply to ETFs with Hong Kong stocks as underlying

No

Please give reasons for your view.

Again, keeping consistent rules and mechanisms is the best way to avoid market disruption and ease implementation for all participants.

21. Do you agree that at a later stage, the new CAS model should be expanded to other equity securities and funds as proposed? If so, when should the CAS be rolled out to these securities and funds?

Yes, roll out time should be: ASAP

No

Please give reasons for your view.

22. Do you agree that that the new CAS model should exclude structured products, equity warrants and debt securities?

Yes

No

Please give reasons for your view.

We would like consistency across instruments.

23. Do you support introducing a price limit during the CAS?

Yes

No

Please give reasons for your view.

This allows for the exchange to explicitly govern what is deemed as an acceptable price during the close removing any ambiguity .

24. Do you support a price limit of 5% during the Order Input Period for all CAS Securities?

Yes

No

Please give reasons for your view.

Year to date, for HSI and HSCEI stocks, this price cap does not appear to affect efficiency in the close period. (see figure 6). For names outside of these indices, a more tiered approach would be appropriate.

25. Do you agree that a further price limit within the best bid and best ask should be applied during the No-Cancellation Period and Random Closing Period?

Yes

No

Please give reasons for your view.

This will help to provide assurances to the market controls are in place.

26. Do you agree that at-auction limit orders should be allowed throughout the CAS?

Yes

No

Please give reasons for your view.

27. Do you think short selling orders with a tick rule should be allowed during the CAS?

Yes

No

Please give reasons for your view.

As long as adequately price protected, short selling in the close will provide additional liquidity and further contribute to market efficiency.

28. If short selling order is to be allowed, should it be at or higher than the reference price?

Yes

No

Please give reasons for your view.

Yes, this would assist in protecting EPs from participants selling down on the close.

29. Do you agree that order amendment and cancellation should be disallowed during the No-Cancellation Period and Random Closing Period?

Yes

No

Please give reasons for your view.

This helps stabilize the imbalance and ensure liquidity only grows.

30. Do you agree that random closing be adopted in the CAS to prevent gaming?

Yes

No

Please give reasons for your view.

31. If random closing is to be adopted, should it be over a period of up to 2 minutes or would you prefer a different duration?

Up to 2 minutes

A different duration: _____

Please give reasons for your view.

32. In the absence of a final IEP, do you agree that the reference price should be used as the closing price and for trade matching?

Yes

No

Please give reasons for your view.

This would be helpful to complete market on close orders at a fair value price.

33. What would be the preferred duration of the CAS?

(i) Same as the proposed model, i.e. 7-minute Order Input Period to end the CAS at 16:12

(ii) 5-minute Order Input Period to end the CAS at 16:10

(iii) Others, please specify:

Approach (i)

Approach (ii)

Approach (iii), please specify: _____

Please give reasons for your view.

34. Do you agree that some features of the new CAS model may also be beneficial for the POS and/or the Trading Halts? If so, which feature(s)?

- Yes, the feature(s): Randomization and support for execution of market orders with no limit price overlap.
- No

Please give reasons for your view.

Without randomization, the auction is open to gaming. Allowing execution of market orders at a fixed reference price allows for a further increase in liquidity.

35. Do you agree that any enhancements for POS and/or the Trading Halts should be implemented later rather than during the introduction of the new CAS?

- Yes
- No

Please give reasons for your view.

36. Do you foresee any issues with your day end processing such as margin calls in the cash market due to the extended trading time for 12 minutes? If yes, how may the issue be resolved?

- Yes, suggested solution: _____
- No

Please give reasons for your view.

37. To maintain the 45 minutes break before the start of AHFT, do you agree that the start time of AHFT to be changed from 17:00 to 17:15? If not, what time do you prefer?

- Yes

No, time that you prefer: We do not see a need for a break.

Please give reasons for your view.

Part D Consultation Questions – Implementation Approach and Timeline

38. Which implementation approach for the securities market would you prefer:

- (i) the development and testing of the VCM, CAS and Trading Halts functionalities are to be implemented together on the AMS/3.8 platform and be rolled out one by one; or
- (ii) (1) the development, testing and rollout of VCM and CAS are to be implemented together on the AMS/3.8 platform, and (2) Trading Halts proposal is to be introduced as part of the Exchange's next-generation trading system, the Orion Trading Platform-Cash; or
- (iii) Others, please specify.

Approach (i)

Approach (ii)

Approach (iii), please specify: CAS is the priority. VCM we believe needs more work.

Please give reasons for your view.

For us, the CAS and VCM (in that order) are important contributions to our daily workflow. Halts, while also important, if descoped would reduce time to market

39. What should be the implementation priority among the three initiatives (i.e. VCM, CAS and Trading Halts) in the securities market?

Please give reasons for your view.

CAS. As emphasized by many brokers and articles on the topic, the market need a more efficient means to execute at the close price. The present close price determination method forces exchange participants to use unnatural methods to try to meet or beat the close. Unwanted side effects include increasing volatility unnecessarily, risking unnecessarily large slippage to the derived close price and exhausting exchange throttles on high volume days in the process.

40. How long do you need to prepare for the rollout starting from the issuance of the specification for each initiatives:

(i) VCM:

a). under 3 months;

- b). 4-6 months;
- c). 7-12 months
- d). >12 months

Please give reasons for your view.

(ii) CAS:

- a). under 3 months;
- b). 4-6 months;
- c). 7-12 months
- d). >12 months

Please give reasons for your view.

- End -

HKEX Consultation Paper on the proposal for VCM and CAS

Supplementary Response

Part B

Question 2

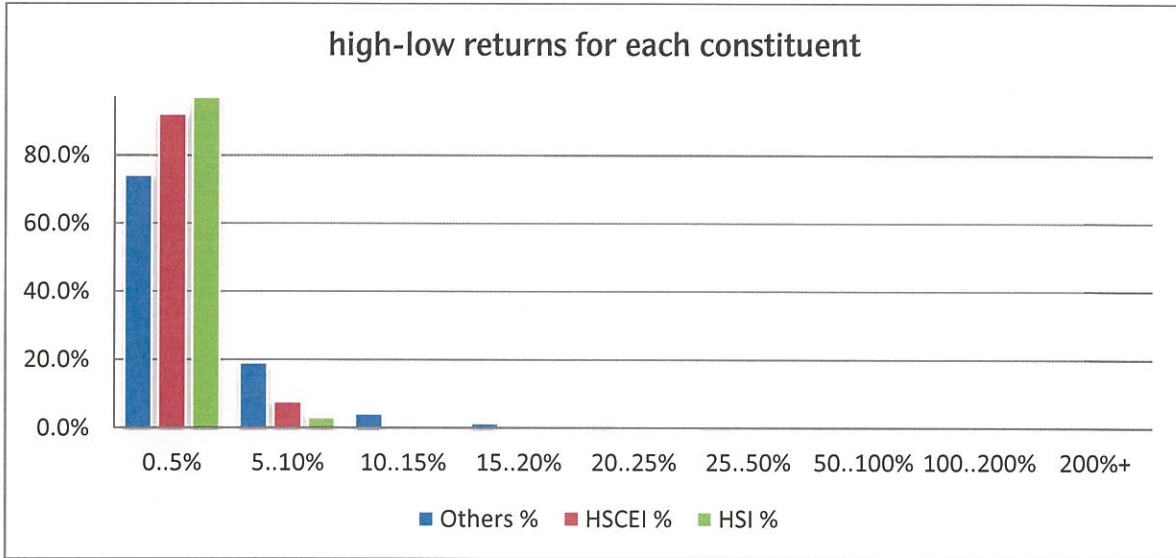


Figure 1: High-Low Returns 2015 YTD (March 27th, 2015)

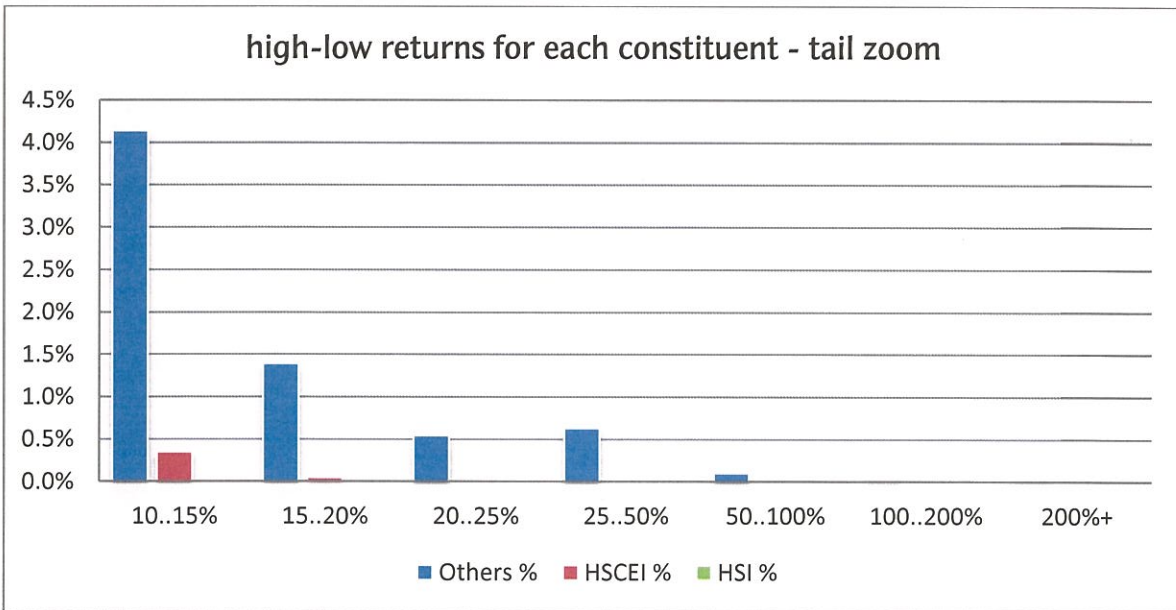


Figure 2: High-Low Returns 2015 YTD (March 27th, 2015)

High Low Return	Others %	HSCEI %	HSI %
0..5%	74.1%	92.000%	96.943%
5..10%	19.1%	7.613%	3.057%
10..15%	4.1%	0.344%	
15..20%	1.4%	0.043%	
20..25%	0.5%		
25..50%	0.6%		
50..100%	0.1%		
100..200%	0.0%		
200%+	0.0%		

Figure 3: High-Low Return by Index

Question 5

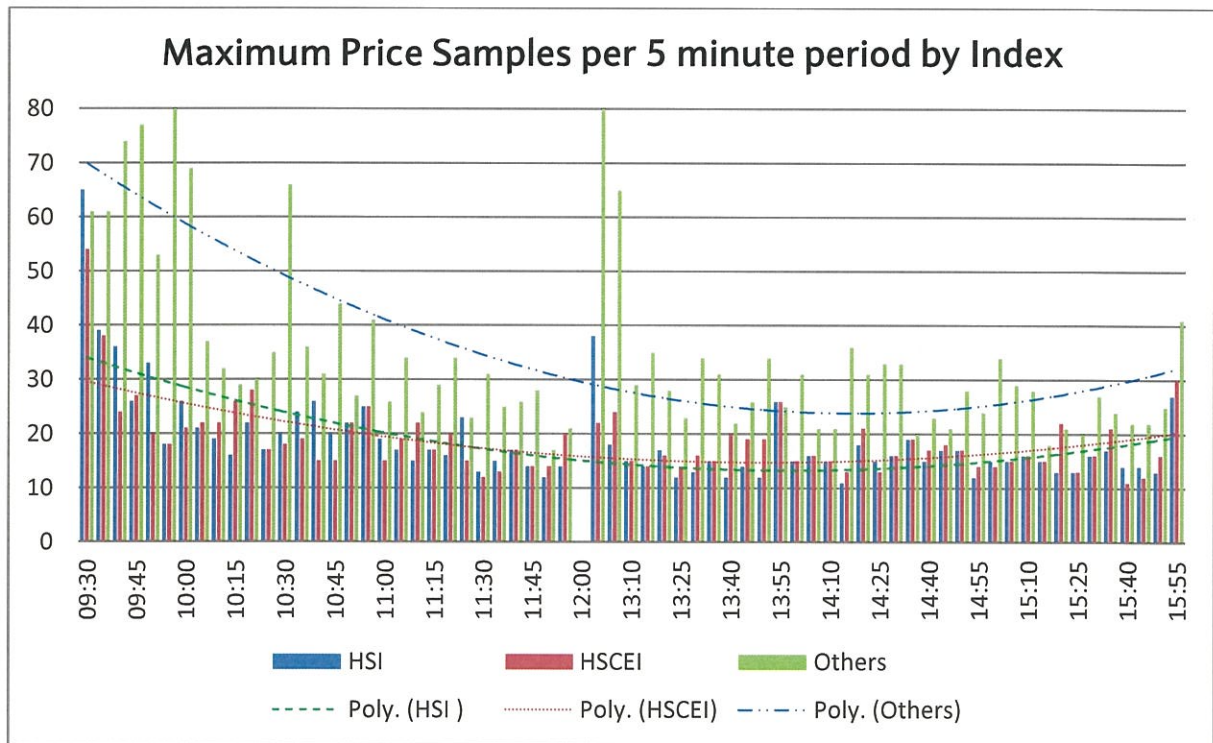


Figure 4: Maximum Price samples per 5 minute period by index

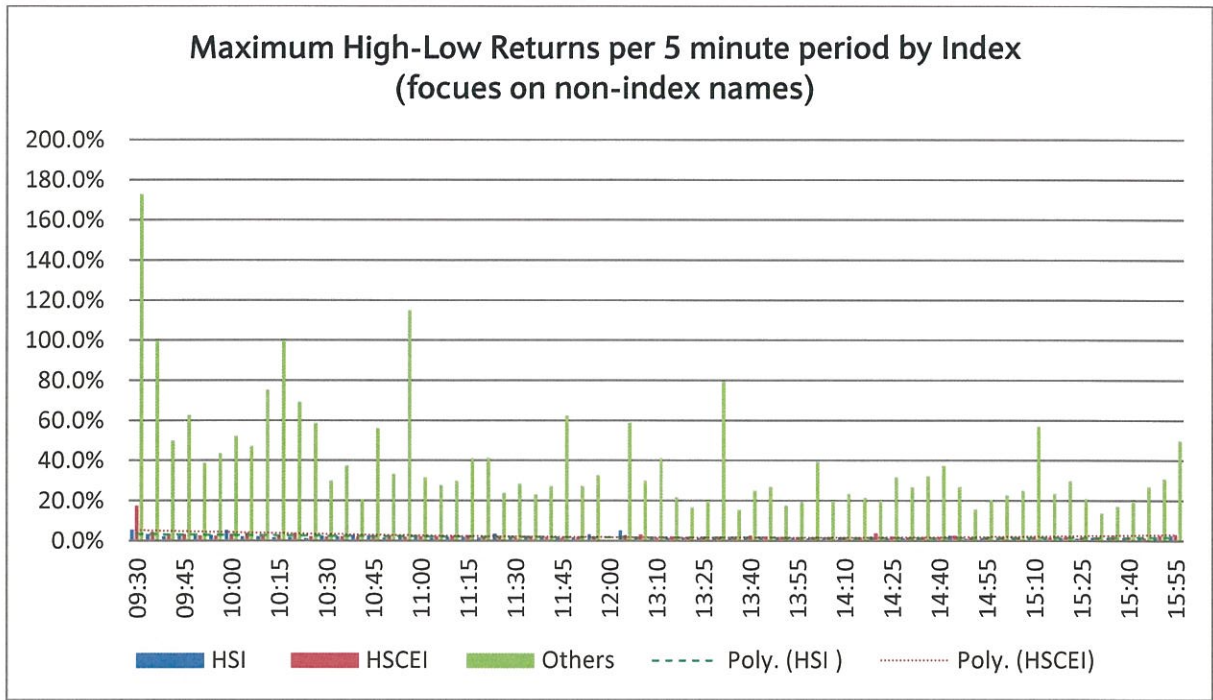


Figure 5: Maximum High-Low returns per 5 minute period by index (non-index names focus)

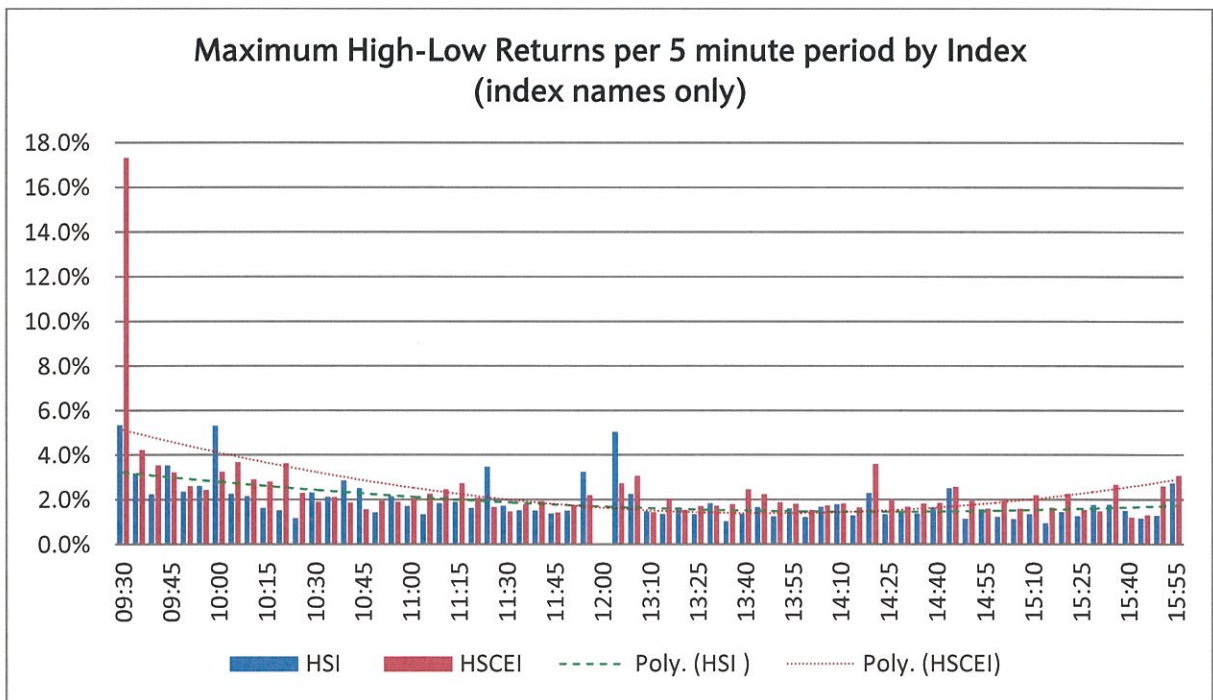


Figure 6 : Maximum High-Low returns per 5 minute period by Index (Index names only)