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.

> This would be good for market stability and investor confidence.

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

■   Yes

☓   No

Please give reasons for your view.

> It makes sense that less liquid securities should be treated differently for the purposes of the VCM. However, we see the need to balance this ideal against simplicity in implementation: a uniform approach will likely be easier for market participants to reflect in their own trading infrastructure.

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 <u>derivatives</u> market?

□   Yes

□   No

Please give reasons for your view.

> We would not object to subjecting other derivatives to the VCM, nor do we see an obvious need for one in the index futures listed above.

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.

> The 15-minute period without interruption ensures the reference price of the closing auction will not be constrained by the VCM. A 15 minute period is sufficient time to allow this to happen. If there were no reference price constraint in the CAS, it would be fine to apply the VCM uniformly during the continuous trading session.

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: _____

Please give reasons for your view.

> Though longer than some peer volatility halts, this timing seems reasonable.

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: _____

Please give reasons for your view.

> Staying consistent with the securities VCM seems preferable, though not essential. That said, for more liquid products, there is an argument for using an average of recent trades. Assuming the VCM triggers are sufficiently wide, either approach seems acceptable.

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.

> This threshold seems reasonable, though we would point out that the triggering level ought to depend on the breadth of securities in the scope of the VCM. The trigger level that makes sense for HSI constituents likely is narrower than makes sense for the lowest liquidity securities.

8. Do you agree with the proposed triggering level for the <u>derivatives</u> market, namely <u>5%</u> 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.

> This seems reasonable. Per response 7, broader inclusion of derivatives into the VCM might warrant a different trigger than was deemed appropriate for the proposed four index futures.

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: _____

Please give reasons for your view.

> Any more than two triggers will most likely indicate genuinely heightened volatility and the market should be allowed to trade uninhibited. That said, the cost of imposing perhaps-unnecessary VCM's seems relatively small, and in the interest of simplicity, this refinement does not seem crucial.

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.

10

> Yes. The VCM may have been triggered by an input error or 'fat finger'. It is important to protect the integrity of the market but it is equally important to allow other market participants to continue to trade in order to allow the price formation mechanism to continue.

11. After the cooling-off period, do you support resuming the same dynamic price limit monitoring mechanism (i.e. ±10% (±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.

> It would be confusing to have two different approaches. The most favored approach should be used consistently.

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

> We prefer to ensure the resumption permits market participants to send orders during the VCM-induced interruption. This should help avoid an unnecessary "timing" race at the end of the interruption. Further, this should help reduce volatility (and allow more efficient price discovery) at the resumption of trading.

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.

> This seems like another dimension where consistency between the two product groups seems more important than other considerations.

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.

> Clearly disseminating the VCM interruption status should help prevent confusing order responses (e.g., no fills to marketable limit orders). More importantly, it will attract liquidity providers, sometimes resulting in an earlier or more efficient resumption of trading, depending on whether trading within the trigger threshold is permitted during the cooling-off period.

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.

> It is important to maintain liquidity in related instruments if the VCM is triggered by an error in order entry. If market sentiment is causing the VCM then presumably it would also have a similar effect in related instruments so there is no need to impose the VCM automatically in related instruments.
> This opinion also depends on the scope of the instrument relationships. A wider scope of instrument relationships would make this refinement more disruptive in our view.

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 important to maintain liquidity in related instruments if the VCM is triggered by an error in order entry. There is no planned VCM for Single Stock Options or Warrants at this stage but any mechanism to inhibit trading in related instruments does not seem clearly beneficial to the market.

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

> Although we see the protective value in rejecting the order that triggered a VCM, we would emphasize this differs from peer volatility interruption schemes (e.g., TSE, KRX).

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.

> It is important that asset managers and other investors are able to hedge risk and track indices. The new CAS model will allow this to happen more effectively as investors will be able to match the closing price.
> Less directly, nearly all peer markets of HKEx have closing auctions for their securities markets. Though consistency is not an argument on its own, in this case it adds weight to our belief that the market will operate more efficiently with a CAS.

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.

> As with the VCM, we see some benefit for many market participants by applying the program uniformly. However, we also see benefits to beginning the program with a relatively narrow set of pilot securities. The intention would be for the pilot period to be relatively short-lived (assuming the transition in the pilot securities were smooth), allowing market participants to operate under the new system without committing the full market.
> Perhaps most importantly, in the event the CAS includes a broader scope of securities, the band on the allowable price range of the CAS (currently proposed as +- 5%) would present a heavy restriction in lower liquidity securities.

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

13

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

■ No

Please give reasons for your view.

> Although the desire for a CAS for ETFs is likely lower than in other securities, we would generally prefer to see a consistent approach that treats ETFs like other HKEx securities.

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: As per above, roll all at the same time

■ No

Please give reasons for your view.

> We see no major objection to staggering the rollout either, particularly in the event the staggering was motivated by a desire to begin the CAS in a set of pilot securities.

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.

> Since the market participants in these derivatives will largely be different from those active in the CAS-relevant securities, the argument for consistency is less strong here.

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

■ Yes

■ No

Please give reasons for your view.

> We are particularly nervous about the impact of price limits in the CAS, as they are likely to: permit settlement values (especially for index calculations) to be determined by overly-constrained conditions; create risk and complexity for passive index managers; and perhaps advantage certain liquidity providers willing to use market orders (as opposed to limit orders).
> We are also very concerned by the potential distortionary effect the reference price can have on the CAS. An unscrupulous market participant might be incentivized to manipulate the reference price in the lower-liquidity final minute of continuous trading, so as to place an artificial constraint on the official close determined in the CAS.
> As discussed earlier, these concerns are only heightened if the CAS is extended to include even lower liquidity securities than already proposed.

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.

> As per the answer to question 23, this applies an unnatural collar on the potential closing price. To emphasize, we further view it inconsistent to allow market participants to enter "market orders" while simultaneously placing a constraint on the price of limit orders participating in the auction. Given the price limit constraint, a limit order that is (effectively) identical in price aggression to a market order could be disadvantaged in price-time priority.

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.

> Similar to our response to question 24, this applies an unnatural collar on the potential closing price. Where the best-bid and best-ask are very narrow there can be no further price formation or reaction to any other market news or market forces.
> Moreover, it does not make sense to apply a further price limit if market orders are allowed. If the reason for the tighter price limits is to "prevent unexpected price volatility due to aggressive at-auction limit orders", then it would seem odd to allow at-auction (market) orders.

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

15

☒ Yes

☐ No

Please give reasons for your view.

> This is the primary order type used by risk-conscious liquidity providers. From our experience with the POS, we view a period exclusively permitting riskier market orders (to the exclusion of risk-conscious limit orders) as unfortunate in two regards: it incentivizes market participants to abandon the risk check of price limits for competitive reasons, and as a consequence, it deters efficient price discovery in the auction.

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.

> Short selling is a legitimate part of the price formation mechanism. Excluding short selling would hinder efficient price discovery in the CAS.

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.

> Participants should be allowed to short sell below the reference price. Short selling is a legitimate part of the price formation mechanism. Limiting short selling to only at or above the reference price would mean the price formation mechanism is not optimal.

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 might help to prevent abusive behaviors in the CAS. With that said, this benefit must be viewed as trading off against the increased risk exposure during the no-cancellation period. The longer this no-cancel period, the higher the risk to market participants bearing market risk of orders they are unable to cancel. On balance, a short no-cancellation period should deter manipulative behavior, the benefit of which should exceed the added risk cost.

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

☒ Yes

☐ No

Please give reasons for your view.

It is a simple and effective way to prevent market abusive behaviour at the close and encourages transparent order entry.

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.

This is sufficient time and in line with other global markets. Any longer would discourage liquidity providers. Shorter would also suffice, but the difference between 30 seconds and 2 minutes is likely immaterial.

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.

We would obviously prefer to see an IEP for every close, but given this is not possible, using the reference price as the official close seems appropriate.

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.

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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):   Ability to short sell.
                         Putting market orders and limit orders on equal footing.
☐ No

Please give reasons for your view.

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At present, we find it very difficult to provide sell-side liquidity in the POS as short
sell orders are not allowed. It would be beneficial to the market and the price
formation mechanism to allow short sell orders in the POS. If nothing else, treating
the previous close as a "best offer" for the purposes of the tick rule would at least
permit liquidity providers to improve price efficiency when the opening price would
exceed the previous close.
Likewise, the ability to send limit orders until 9:20 would be beneficial to the price
formation mechanism and would add more liquidity to the POS. As mentioned
earlier, we are troubled by the fact that being conscientious about risk prevents us
from providing as much liquidity in the POS as we otherwise would.
We consider each of these constraints as partial explanations for why the POS volume
in HKEx securities is much smaller (as a percent of total traded volume) than in other
APAC markets. In addition to attracting more liquidity to the POS, we believe lifting
both constraints would reduce unnecessary price volatility in the opening price.
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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.

> We view the changes to the CAS and our proposed changes to the POS as higher priority than the Trading Halts. It may be simpler for market participants to implement all changes at once, but it might also be a large set of changes to digest at once. On balance, we would prefer to see the introduction of the CAS and the adaptations to the POS not be delayed by plans for the Trading Halts.

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.

> The change is not significant in the context of our post-trade processes.

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: __17:00_____

Please give reasons for your view.

> While not crucial, maintaining the same schedule of AHFT seems preferable to maintaining the same intermission between the regular and AHFT sessions.

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: _____

Please give reasons for your view.

> This would be the most efficient way of implementation

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, VCM, Trading Halts
> We further consider the POS enhancements as comparable priority to the CAS. The VCM and Trading Halts are much lower priorities, primarily because we do not perceive a significant market failure that they will address. By contrast, both the introduction of the CAS and the improvements to the POS address inefficiencies in the securities market we can readily observe on a daily basis.

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;

20

■ b). 4-6 months;

■ c). 7-12 months

■ d). >12 months

Please give reasons for your view.

> We would not require a significant amount of time to adapt to this change. The binding constraint would likely be our market data providers in being able to transmit the VCM status properly.

(ii) CAS:

■ a). under 3 months;

■ b). 4-6 months;

■ c). 7-12 months

■ d). >12 months

Please give reasons for your view.

> This change is far more substantial in our view. We view a pilot program in a small set of securities, to help market participants get acquainted with the new dynamics, as more useful than a long lead-time prior to rollout.
> As above, the longest lead-time would likely come from our market data providers in having to prepare to disseminate the new CAS-related information.

- End -