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.

> You have outlined the principal reasons for the desirability of a VCM in your Chapter 1. There is an international consensus that markets should have in place suitable VCMs to deal with volatile market conditions and errors, which can potentially have knock-on or contagion effects. Other leading markets around the world have introduced VCMs. The case for VCMs is that a market-disruptive event caused by a single market participant could potentially disrupt the broader market and other related markets via contagion effects. Although all market participants should have appropriate controls and risk management systems in place to avoid and minimize errors, errors on the part of individual market participants can never be ruled out. A VCM can contain their impact, and hence the economic and psychological cost, of a disruptive event should it occur.

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.

> Our preference ultimately would be that it applies to all stocks listed on the Exchange. In principle, the reasons for adopting a VCM apply to all stocks, not just to the larger ones in those indexes. However, we strongly believe that adopting a VCM for the index stocks named above is preferable to not adopting a VCM. In addition, when the VCM is expanded to other stocks, which would include less liquid ones than those in the two indexes name above, it may be advisable to have a wider price band for such less liquid stocks.

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.

> Again, we think the principles apply to all instruments, and over the long term don't think there's a need to limit the VCM to just the more active contracts. The logic of adopting a VCM holds whether a stock is in a particular index or not. However, as noted in #2 above, price bands would need to be adjusted for illiquid and low-priced stocks.

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.

> As indicated in the previous answers _____ supports the current VCM proposal however our preferred alternative would be to allow unlimited triggers and then not suspend the VCM in the last 15 minutes of trading. It is important for price the discovery process to unfold into the close to ensure that the closing price reflects market conditions. Unlimited VCM triggers would allow the market to find its level while providing a desired constraint on excessive volatility. We would also support an extension of VCM into the CAS to ensure approprate price discovery and reduce execution risk. The London Stock Exchange is an example of a CAS with a VCM that works well.

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.

> As noted in your paper, VCM mechanisms in a number of other major markets use a similar 5-minute look-back for the reference price. This will allow sufficient flexibility for the market to adjust to changing economic and market conditions while still maintaining the protective band against anomalous, disruptive price movements. However, for thinly traded securities--when these are included in the VCM--we would propose that a fallback mechanism be adopted, such as taking the mid between the best bid and ask of the most recent quote in the past 10 minutes.

6. Do you agree with our proposed reference price for the <u>derivatives</u> 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.

    > Please see our answer #5.

7. Do you agree with the proposed triggering level for the <u>securities</u> market, namely <u>10%</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.

    > The triggering level should be narrow enough to constrain anomalous, disruptive events without interfering with the price discovery process to the degree possible. Triggering events should be relatively rare. The 10% triggering level appears to result in a relatively infrequent trading halts while maintaining the purpose of the VCM.

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.

    > However we do think a 10% trigger for all instruments would reduce overall complexity but appreciate that different triggering levels may be called for based on liquidity, a criterion that would become a consideration when the decision is made to expand the VCM to stocks outside the HSI and HSCEI.

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: <u>Unlimited</u>

Please give reasons for your view.

> In general,   · believes that the VCM principle is a good one and as such should not be restricted to just two per session. However should the two-trigger limit be adopted we would suggest and support a review of these limits at a later stage.

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.

> We understand the logic of allowing trading within the limit; it would accommodate a change in market sentiment during the 5-minute period, allowing trading to resume. However   . would prefer that an auction process is adopted as part of the trading halt to enable the market to find the new market-clearing level. This is a model that works well in a number of other markets.

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.

> Yes, for reasons given above.

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

> As pointed out in #10, we would advocate the use of an auction mechanism at the end of the trading halt. Longer term, we think that would be advisable but do not advocate delaying introduction fo the VCM pending such a development.

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.

> 5 minutes will be adequate to allow market participants to assess market conditions and respond with additional liquidity. In addition, 5 minutes is the single most frequently used cooling off period in major markets, which suggests that experience and precedent supports this duration. In addition, the cooling-off period cannot be greater than the observation period for establishing the reference price, or the reference price would be stale.

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.

> As noted in the HKEx analysis, it is important for market participants to get relevant market data, including price, price limit, and trading state and time of the VCM expiry/resumption in order to make informed decisions and to provide better transparency.

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.

> Yes, subject to the following caveat: The interruption of trading in a particular instrument could have implications for market-making activities in a related instrument.

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.

> Same answer as #15 above.

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

>   strongly supports adoption of a VCM model. Although we have indicated a preference and suggestions towards other VCM models that exist we believe it is important for HKEx to adopt the VCM proposal such as this to bring the exchange in line with market practices in today's trading environment. We hope the HKEx will consider comments and suggestions including those in this response, but believe that adopting a VCM is an important step that the exchange should take. Enhancements can come later once the market has gained experience with the initial model.

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.

believe it is very important for the Stock Exchange of Hong Kong to have a closing auction, just as all major markets around the world, and all but a few developing-country markets, already have. It is critically important to the status and development of Hong Kong as a leading global financial centre to have such a closing auction mechanism, which would bring it in alignment with almost universally accepted practice. Providing a mechanism to easily achieve the close will ultimately reduce slippage to funds (such as Index) that are benchmarked to the close.

We believe that implementing a CAS will greatly improve order during major index rebalance days (for example MSCI, FTSE and HSI) where the volume traded in the affected names during the last minute can be huge. In many cases this can account for over 90% of that days trading and represent multiple days volume in those securities. A CAS will ensure that that there appropriate time for all participants to react to this volume surge.

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.

> In principle, we believe the CAS mechanism is widely used because it is effective; eventually we believe it should apply to all stocks. In particular, partial adoption of the CAS could give rise to situtaions where some of the constituents of other indices will be in the CAS while others are not, creating inconsistency. However, because some stocks outside the large caps are less liquid or low-priced, the CAS may require some adjustment for such issues, which could add complexity. Hence, initially at least we agree that the model should be applied to these indexes.

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.

> We believe the CAS is a good idea, proven in markets around the world, and consequently do not see any good reason to limit its application to a subset of securities other than those named in #22.

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 soon as practicable__

☐ No

Please give reasons for your view.

> As noted, we believe the CAS model has been proven in market around the world and in principle all stocks should hae a CAS. We note our qualifications in our answer to question #19 and #22 below.

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.

> Structured products, warrants, and debt securities have very different characteristics from equities; in particular, they generally do not have MOC execution needs, as noted in the text. Hence there's less market demand for a CAS for these instruments and the CAS being considered in this consultation is likely less suitable for them. This is confirmed by market practices elsewhere.

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

☒ Yes

☒ No

Please give reasons for your view.

> A price limit can be justified to contain extreme volatility. As an alternative to a fixed price limit we would support an extension of VCM into the CAS as is the case in other developed markets (e.g. London Stock Exchange). This would ensure that there is approripate time and opportunity for the market to find the market clearing level during the CAS phase. An unintended consequence of adopting price limits in the CAS is that it could shift volatility into the pre-closing period. However if CAS is implemented with a price limit we think it crucially important that the price limit not be too narrow, as discussed below in #24.

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.

> We believe the price band should be wider, at least 7.5%, which would encompass approximately four standard deviations of price movements on major rebalancing days. The price band should be wide enough to be relatively un-restrictive while fulfilling the purpose of providing a constraint on extreme volatility. A tight price band discourages trading in an auction as it increases order incompletion risk and introduces more volatility around the limit of the band. The unintended consquence of a too-narrow band for the closing auction is that it could drive more volume into the pre-auction period, increasing volatility prior to the auction and reducing the utility of the auction itself. As shown in the consultation document (ps. 60-61), all major exchanges around the world, with one exception, have either no limit during the CAS or a limit of 10% or more. The one exception is Taiwan, which has a limit of 7% relative to the previous day's close. Hence a limit of 7.5%-10% would already be at the low end of the range relative to other markets. A narrower limit than 7.5% would unnecessarily hamper the price discovery process.

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.

16

> No, we think this is an unnecessary constraint on the price discovery process. Limit orders are accretive flow to market orders and restricting the allowable price range would, in our view, be more likely to hamper liquidity than constrian volatility.

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

☒   Yes

☐   No

Please give reasons for your view.

> At-auction limit orders add flow to market orders and help to maximize liquidity and facilitate price discovery. Limit orders also reduce pricing uncertainty, hence volatility in the closing 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 important to improve liquidity and reduce volatility by allowing short sales to offset an imbalance on the long side. Short selling contributes to accurate valuation and provides a mechanism for hedging and risk management. Short selling during the CAS will help make the CAS more liquid and efficient.

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.

> The uptick rule is sufficient. Constraining the allowable short selling further would only reduce the contributions of short selling to the liquidity and efficiency of the CAS. It would also introduce an asymmetrical bias in the closing auction, hampering the market's ability to determine an economically efficient closing price.

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.

> We understand the rationale of the HKEx with this requirement. We think it is likely superfluous given the other design features of the CAS, such as the random close. However, this could be an aspect of the CAS subject to review once there has been experience with the CAS.

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

☒ Yes

☐ No

Please give reasons for your view.

> We agree with the reasoning in the consultation, which is also confirmed by experiences in a number of other markets. A random close is an important anti-gaming mechanism that we believe represents best practice and should be adopted. It is simple to implement and adds only minimally to market complexity. A random close also precludes the need for last-minute/second position adjustments that can occur with fixed closing times. As a consequence, a random close reduces latency as well as potential capacity issues. In addition, a random close improves price discovery by removing the incentive to delay displaying buying or selling interest.

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: ___1 minute or 30 seconds_____

Please give reasons for your view.

> We believe a two-minute window for the random close is longer than necessary. We believe that a one-minute window, or even 30 seconds, would be sufficient.

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.

> The existing 5-minute median prints mechanism is familiar to the Hong Kong market and would minimize development and education efforts. A VWAP reference price would be better on theoretical ground and hardest to game, but at the cost of added complexity. This could be a possibility to re-consider at a later stage.

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.

> The seven-minute input period provides adequate time in which orders can be entered, amended, and cancelled.

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):   The CAS mechanism itself, that is, an auction process.

   ☐   No

Please give reasons for your view.

> We believe the CAS mechanism, for all the reasons discussed in the HKEx consultation, the experience of other markets would be optimal for the opening as well as the close.

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 think it critical for the HKEx to adopt a Closing Auction Session. An enhanced POS and trading halts can come at a later stage in order to reduce the education required and increase market acceptance of the principle of the CAS. Similarly, if based on market feedback HKEx should decide that the VCM model requires further development from what has been proposed in this consultation, we would recommend launching the CAS rather than waiting in order to launch the CAS and VCM simultaneously.

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: _____

Please give reasons for your view.

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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.

> Implementation of VCM and CAS, but especially the latter, are high priorities. They should be introduced as soon as reasonably practical.

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.

> A CAS is the first priority. As noted in our introductory comments, all major markets in the world now have a closing auction session, as do all but a few developing markets. Hong Kong is an anomaly in lacking one. More substantively, the absence of a CAS harms the Hong Kong stock market by raising costs and risks. If the VCM could be introduced at the same time as the CAS, that would be fine. However, if the VCM model should require additional development, for example as a result of market feedback, we do not favour waiting to introduce the CAS but to introduce it quickly, followed by the VCM and Trading Halts when practical.

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.

> In principle, the VCM, but especially the CAS, should be introduced as soon as practicable. However feedback from brokers indicate they require adequate time to design systems, train personnel, educate clients, etc.; market participants should be given adequate notice and preparation time once the details have been decided upon.

(ii)   CAS:

☐   a). under 3 months;

☒   b). 4-6 months;

☐   c). 7-12 months

☐   d). >12 months

Please give reasons for your view.

> Again, the CAS is a major requirement for Hong Kong to be home to a stock market that is globally competitive. Its introduction should be a high priority while providing industry with adequate preparation time. Consideration should be made of any major index rebalance events that could coincide with a CAS launch. Need to ensure that there has been appropriate lead time and experience using CAS prior to a major event.

- End -