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Hong Kong Securities and Futures Commission—The Conversion to a Demutualized Exchange: The Hong Kong Regulator’s Experience

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14.1 The Need for Reform

In his budget speech on 3 March 1999, the Financial Secretary of Hong Kong announced a three-pronged reform programme for the securities and futures markets in Hong Kong. This reform programme comprised:

- fundamental change in the market structure accomplished through the demutualization and merger of the exchanges and clearing houses;
- enhancement of the financial infrastructure to improve risk management, increase efficiency, and reduce cost; and
- regulatory and legislative reform to improve the supervisory framework and protection of market participants.

This chapter is concerned only with the demutualization and merger of the exchanges and clearing houses. This project, which began in earnest only a few months before the Financial Secretary’s speech, was substantially completed just over 15 months later upon the listing by way of introduction of the shares of Hong Kong Exchanges and Clearing Limited (HKEx) on the stock market operated by its wholly-owned

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subsidiary, the Stock Exchange of Hong Kong Limited (SEHK). Today, HKEx is the parent company of SEHK, the Hong Kong Futures Exchange (HKFE) and their respective clearing houses. Despite the relative speed with which the reform was implemented considerable and continuous work was undertaken by the government, the exchanges and clearing houses and their respective advisers, and the Securities and Futures Commission (SFC) to ensure the success of the project.

Government Support and Pressure

A policy paper entitled *A Policy Paper on Securities and Futures Market Reform*—which was largely drafted by staff of the SFC—was issued by the Government of the Hong Kong Special Administrative Region of the People’s Republic of China at the time of the budget speech. This outlined the rationale and need for reform. The government stated that it was not prepared to let Hong Kong fall behind in the continuously changing international environment and that this reform therefore needed to happen quickly. It set out the following timetable within which the project was to be completed:

- 3 March 1999 : financial Secretary announces the proposal in Budget Speech and Policy Paper issued.
- 30 September 1999 : members of the two Exchanges to agree valuations of merging entities (SEHK and HKFE) and merger ratio (see next section below), and vote upon the demutualization.
- 31 March 2000 : enactment of enabling legislation and implementation of merger.
- 30 September 2000 : listing of HKEx on SEHK.

The policy paper stressed that the government did not underestimate the difficulty of achieving the requisite 75% majority of votes in each of the meetings of the members of the exchanges required in connection with the merger. However, given the importance of the reform to the strategic and competitive position of Hong Kong as an international financial center and the benefits accruing to members of the exchanges, the government was hopeful that the members of the exchange would reach agreement on the terms of their relative interests in the new holding company and achieve the necessary majority to

approve the schemes of arrangement. The government acknowledged that there would undoubtedly be difficulties along the way but was satisfied that all obstacles to integration could be overcome with the cooperation of the members of the bodies concerned.

The government recognized the complexity of the task involved. To ensure that the proposed reform was implemented swiftly and smoothly and that the exchanges received the advice and assistance they required from the government, the project was driven by a team within the Government's Financial Services Bureau. As the securities and futures market regulator, the SFC was also closely involved. In particular, the commission sought to ensure that the existing market structure continued to operate effectively during the period of transition, that the procedures to implement reform were fair and transparent and conducted in accordance with all applicable legislative and regulatory requirements and accepted principles of good corporate practice, and that the new market structure would fully reflect the important public role to be performed by the HKEx.

The government made it clear that failure to implement reform was not an option. The significant changes occurring in leading markets worldwide, with upgrades of infrastructure and technology, made it essential for Hong Kong to implement reform in order to maintain its competitive position and face global challenges. The policy paper stated: "The government will spare no effort to work with the Exchanges and Clearing Houses to effect these important strategic reforms. These are reforms dictated by global market forces, as well as domestic voices for change. If market participants are unable or unwilling to effect such reforms in the expeditious manner dictated by the pace of change in the global market, then in the larger interests of Hong Kong, the government will pursue alternative action that will achieve the primary objectives of these reforms.

This may include, among other things, review and necessary reform of the current market environment and governance structures of the Exchanges and Clearing Houses in order to induce competition, promote investor interests and, above all, ensure that the interests of the Exchanges and the securities and futures market as a whole are sufficiently safeguarded and suitably balanced as against those of the members. Meanwhile, the government will continue to pursue its established policy objectives to improve and strengthen the clearing infrastructure in Hong Kong through the integration of the current sector-based clearing and settlement systems to improve risk management, enhance market stability and integrity, and generally better protect public interests."

14.2 The Reform Process

14.2.1 Relative Interests in NewCo

Implementation of the demutualization and merger required the then members of the exchanges to exchange their shares in their respective entity for shares in the new company that was to become known as HKEx (NewCo). This required valuation of the businesses of the exchanges as then constituted and/or of NewCo following the merger of those businesses. Valuation of the exchanges permitted the fixing of a ratio for the relative interests which the current members of each of the existing exchanges collectively would have in NewCo.

The exchanges each appointed external financial advisers to advise them in relation to the appropriate methodologies to apply in valuing the exchanges and to assist generally in implementing the demutualization. There had to be transparency, consultation and due process for the valuation of the relative interests of the exchanges and the relative proportion of shares in NewCo. The government proposed that the exchanges and their members (and their respective external financial advisers) should consult together and reach agreement on this between themselves.

Merrill Lynch (appointed by SEHK) and Morgan Stanley (appointed by HKFE) were instructed to value the businesses of the two exchanges and negotiate their respective interests in NewCo. This exercise began with an exchange of information, cross due-diligence and a discussion of valuation methodologies. The parties agreed that the best basis for valuation of both exchanges was discounted cash flow (DCF) and negotiated the valuation drivers, terminal values and discounts. The government's financial adviser, HSBC, and its business consultant, McKinsey & Co., monitored the parties' progress, provided assistance and kept the process on track. One significant area of contention was the treatment to be given to HKSCC, the securities clearing house (see section below on Clearing Houses), and the extent of any value attributable to SEHK, which generates most of HKSCC's revenues.

The final proposal put to members of the exchanges in the context of the scheme of arrangement (which valued the exchanges' respective shares in HKEx as SEHK : HKFE (70 : 30)) was as follows:

- For each SEHK share : 805,000 HKEx shares.

- For each HKFE share : 1,393,500 HKEx shares.
- Cash alternative at HK\$3.88 per share for specified number of shares.

The government's agreement that the exchanges could impose a moratorium on new trading rights for two years; thereafter they could be issued by SEHK for HK\$3 million (US\$385,000) and by HKFE for HK\$1.5 million (US\$192,500).

The sensitive subject of how to deal with Hong Kong's fixed commission structure for securities transactions which provides a minimum income for stockbrokers was left for later discussion between HKEx and the government.

14.2.2 Procedures Required

Consistent with the principle that the implementation of the reform should, in so far as practicable, follow normal commercial and legal procedures, once agreement had been reached on the exchanges' relative attributable interests in NewCo, the demutualization and merger was implemented principally by two parallel schemes of arrangement, one applying to SEHK and one to HKFE. Each scheme of arrangement would be conditional on the other proceeding.

The schemes of arrangement followed the normal procedure applicable under the *Companies Ordinance* and took account of the requirements of applicable codes—including compliance with the Takeovers Code—and established regulatory procedures. Meetings of the members of each of the exchanges were convened to consider and vote on the relevant scheme of arrangement. The majority necessary to approve the resolution proposing the scheme was a majority in number of the members representing three-fourths in value of the shares present and voting (whether in person or by proxy). When the resolutions were passed, an application was made to the Court for the sanction of the schemes of arrangement. Following sanction by the Court and satisfaction of other conditions to which the merger was subject (such as the reorganization of the membership of HKSCC, SEHK's clearing house (see below), and the passing of appropriate legislation to repeal and replace, or amend, provisions of existing ordinances), the schemes of arrangements became effective and the demutualization and merger of the market operators under NewCo was implemented.

The negotiation of the terms apportioning the exchanges' respective interests in NewCo and the recommendation to members as to how to

vote in relation to the schemes of arrangement were two of the critical stages of the process towards merger which were undertaken by the management and boards of the exchanges and their respective advisers.

14.2.3 The Clearing Houses

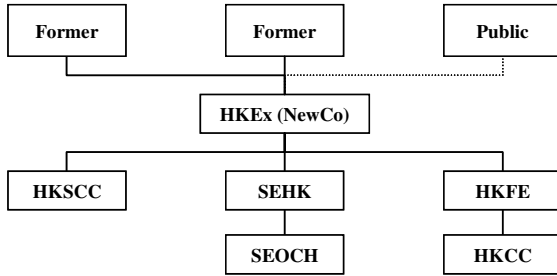
HKSCC forms an integral and important part of the operations of Hong Kong's securities market generally and of SEHK's operations in particular, and its inclusion in the merged business of NewCo was essential and seen to enhance the value of NewCo as a whole. At that time, HKSCC was a company limited by guarantee which had no issued shares and, accordingly, no shareholders or owners. Its members were SEHK and five banks (Bank of China, Bank of East Asia, Hang Seng Bank, HSBC, and Standard Chartered Bank), each of which had undertaken to contribute up to a specified amount (HK\$25 million in the case of SEHK and HK\$5 million in the case of each of the banks) in the event that HKSCC was wound up while it was a member or within one year thereafter. None of the members of HKSCC had any right to receive any dividends or other distributions of profit nor a right to receive anything on a solvent liquidation of the company.

As there was no financial value in the membership of HKSCC it was reasonable that its members would not receive any allocation of shares in NewCo in respect of HKSCC. Accordingly, during the transition leading to the integration of HKSCC into NewCo, consideration had to be given to relieve the five member banks of their guarantee obligations in respect of HKSCC and for NewCo to put in place replacement arrangements so that creditors were not prejudiced.

The SEHK Stock Options Clearing House (SECH) and the HKFE Clearing Company (HKCC) are the other two clearing houses currently recognised by SFC. Both of them are wholly-owned subsidiaries of their respective Exchanges. SECH serves as the clearing house for the stock options trade under the SEHK while HKCC serves as the clearing house for all futures trades of HKFE. These two clearing houses remained wholly-owned subsidiaries of the respective exchange (see diagram below) throughout the demutualization and merger.

Following the merger, all three clearing houses are now being fully integrated as a stand-alone clearing entity that will operate in parallel with the trading operators. The integrated clearing entity will provide centralised clearing and settlement services for all trades on the securities and futures market (Figure 14.1).

Figure 14.1. Diagram of the HKEx Group After the Merger



14.2.4 Advisers to Government

As the government had quite internationally put itself in the driver's seat in order to see this reform through, it needed to appoint professional advisers to assist it in discharging its role. The government's advisers were as follows:

- Financial : HSBC Investment Bank
- Business : McKinsey & Co.
- Accounting : KPMG
- Legal : Allen & Overy

Between them, these advisers had considerable involvement and input into the project from start to finish. HSBC Investment Bank was appointed to oversee and facilitate the negotiations between the two exchanges on valuation of their respective shares in NewCo. They also proposed and structured a cash-alternative element to the financial deal, which was to be offered to exchange members by NewCo in exchange for the members' shares in their respective exchange. Furthermore, for purposes of achieving consistency in the documentation prepared for members of the exchanges in the context of the two schemes of arrangement, and to ensure that the government remained in control of the transaction, HSBC drafted the circulars to shareholders which described the proposed transaction, outlined the proposed new structure

and organization of NewCo, and set out the voting procedures and terms to implement the schemes of arrangement. The consequence of this was that the two exchanges' circulars were substantially similar except for the letters from the board of directors and the financial adviser.

McKinsey & Co. acted as adviser to the government in relation to the proposed structure of the NewCo group. They had numerous meetings with the senior management of the exchanges and clearing houses, the SFC and government to determine what business model could best balance the potentially conflicting profit motive of NewCo—requiring it to act in the best interests of its shareholders—with the public interest, and reflect NewCo's role as a public utility responsible for providing and maintaining the securities and futures markets in Hong Kong. McKinsey & Co. developed a blueprint which was outlined in detail in a second policy paper entitled *Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre* issued by the Financial Services Bureau of the government in July 1999. A discussion of the principal checks and balances, which were put in place to deal with conflicts of interest are described in the above Chapter 5 prepared by the Securities and Futures Commission (SFC) entitled *Demutualization of Exchanges: The Conflicts of Interest*.

KPMG was responsible for developing the pro-forma financial statements for NewCo to be provided to the members of the two exchanges in the circulars to be issued in the context of the schemes of arrangements, and for advising HKEx on the accounting methodology to reflect the merger of the various entities which would comprise the HKEx Group, and generally for liaising closely with the creditors of the entities involved in the merger.

Allen & Overy acted as legal advisers to the government and HKEx throughout the reform process. They drafted new constitutions for HKEx and its new subsidiaries, which reflected both the group's new profit making motive and the checks and balances required to safeguard the public interest. They also drafted the schemes of arrangement and company secretarial documentation needed to record the implementation of the merger particularly from HKEx's perspective. The exchanges each appointed their own legal advisers to provide them with the legal advice they required throughout the process.

Throughout the fifteen or so months it took to structure, organize and implement the reform, the SFC was closely involved with the government and its advisers and generally gave regulatory input where this was required. Numerous policy issues arose in the context of the structure of the new holding company (not least as regards the nature of

the checks and balances required to safeguard the public interest), the review and rationalisation of the division of regulatory responsibilities between SFC and the exchanges (see next section below), the drafting of implementing legislation, and the formal approval of changes to constitutions, rules and codes, and arrangements governing the conduct of business of the Exchanges and Clearing Houses.

14.3 Rationalized Market Regulation

Following the publication of the government's policy paper in March 1999, senior management of the SFC, the two exchanges and HKSCC conducted a review of the then current regulatory framework governing the securities and futures market and of the possible alternative options for the future division of regulatory functions between SFC and HKEx. The review focused on three main areas, namely market surveillance, supervision of intermediaries and listing and corporate finance functions.

Working groups (consisting of staff of the SFC and exchanges) set up to look at each area of review felt unable to make any recommendations as to which of the options presented in their respective reports was best for the future. This was due to a reluctance on the part of the executives and staff of the two exchanges and HKSCC to be seen to be advocating changes to the current regime before the members of the two exchanges had voted in favour of demutualization and merger. Also, the exchanges and HKSCC thought that they were not well placed to consider the future business strategy of HKEx, and that as the future division of the regulatory functions between SFC and HKEx would feature in that business strategy, this should properly be left to another authority which was able to consider such matters from HKEx's perspective.

The government and the SFC accepted those concerns, and acknowledged the need for HKEx's business strategy to be considered before any definitive decision as to the division of the regulatory functions was made. However, to advance the discussion, the government asked the commission to indicate the market regulator's view as to the future division of the regulatory functions between the SFC and HKEx. On the basis of the SFC's recommendations, and following discussions between the government and its advisers and under the Co-ordinating Committee on Market Structure Reform—a committee set up by the government consisting of the Chairmen of the exchanges and the commission, representatives of the broking community, and government to consider

the public interest aspects of the proposed reforms—chaired by the Secretary for Financial Services, a model was produced. The paragraphs below summarize the model recommended by the SFC and endorsed by the government for the division of regulatory functions between the SFC and HKEx following the merger. This structure is now in place.

14.3.1 Market Surveillance

In relation to market surveillance, the division of functions remains largely intact, albeit with clearer delineation and refinement of respective responsibilities in order to reduce areas of overlap and inefficiency. The separation of functions between HKEx and SFC is being formalized by the introduction of clear written procedures.

As a commercial organization, HKEx's surveillance functions have become more business-oriented. Thus, its market surveillance unit focuses on trading operations and risk management, which include: (a) enforcement of trading and clearing rules and detection of trading malpractices by users (liaising with the SFC as necessary in relation to those which may involve statutory offences), (b) maintenance of market transparency by monitoring price and turnover movements on a real-time basis and requiring prompt disclosure of price sensitive information, (c) assisting in the risk management process by monitoring exceptional concentrations in positions and unusual price fluctuations, (d) interaction with market participants, including handling of disputes in relation to trading matters, and (e) cross-market surveillance of HKEx's users. As a participant in the Intermarket Surveillance Group (an international group of exchanges set up to exchange information on surveillance of trading clearing activities), HKEx contributes information in respect of the markets under its operation and conducts surveillance for a number of specific types of cross market manipulation.

With wider statutory powers, SFC, as the oversight regulator, is primarily responsible for detecting market malpractices with statutory implications. The SFC's market surveillance activities therefore include: (a) scrutinizing market activities to detect potential breaches of laws relating to the securities and futures market, (b) conducting investigations of possible statutory offences that fall within its jurisdiction, including those commenced on referrals from HKEx, other agencies and complaints from the public, and (c) overseeing the surveillance actions undertaken by HKEx and performing cross-market surveillance of activities between HKEx markets and non-HKEx markets.

14.3.2 Intermediaries Supervision

In relation to Intermediaries Supervision, most of the functions formerly performed by the exchanges in the prudential regulation of their members have been moved to the SFC. However, HKEx continues to monitor particular aspects of the business of intermediaries so that it may assess and manage the risks inherent in the operations of its subsidiary business units.

Prior to the merger, the exchanges were primarily responsible for the routine inspection of their members' businesses, for monitoring their compliance with conduct rules and the liquid capital requirements and for ensuring that their members have in place proper systems of management and control. The commission, however, retained a shared responsibility for all of those matters and was often required to act in response to regulatory concerns, particularly where the necessary response extended beyond the scope of exchange's authority. Transferring the primary responsibility for those matters to SFC removed duplication and overlap and ensured that a comprehensive response to regulatory issues could be made by the commission as primary regulator.

This change is set against the background of risk management and the enforcement of compliance with proper trading practices. HKEx still needs to retain a capacity to ensure that its risk management measures are adequate and that its trading rules are properly complied with.

14.3.3 Listing/Corporate Finance

In relation to Listing/Corporate Finance, the division of functions remains substantially as before the merger, albeit with improvements in efficiency within SEHK and in the coordination of functions undertaken by both the SFC and SEHK. This necessarily involved a re-examination of the allocation of resources within the SEHK Listing Division and an examination of its functions and work processes. At the time of the policy paper, the SFC contemplated entering into a new Memorandum of Undertaking with HKEx which would clarify the standards to be met by SEHK (and HKEx) in performing its functions in this area and provide for greater interaction between the two bodies. However, this has not yet been done.

As contemplated in the policy paper, and in order to remove the conflicts of interest which would arise if SEHK were to supervise its own holding company, SFC has become responsible for all matters regarding

HKEx which would, in the case of any other listed company, be dealt with by the Listing Division of SEHK.²

14.4 Implementing Legislation: Exchanges and Clearing Houses (Merger) Ordinance

Legislation was required to implement certain aspects of the reforms and introduce a new regulatory framework to cover HKEx. A short summary of the principal provisions of the legislation are set out in the Appendix. The legislation fell broadly into two categories, namely: (i) the introduction of new regulatory checks and balances which required a statutory backing to instill the appropriate spirit of compliance, and (ii) consequential amendments flowing from changes made to the then existing regulatory framework.

As well as considering in detail what changes should be brought about by new legislation, much time was spent by the SFC and exchanges reviewing the rules of the exchanges and Clearing Houses to determine what impact the proposed new regulatory framework would have on the trading and clearing rules. For example, the transfer to the SFC of responsibility for the supervision of brokers, the introduction of the concept of a “trading right”, and the redesignation of brokers as “exchange participants” all required changes to be made to the relevant rules and the introduction of new provisions in SFC’s *Code of Conduct for Persons Regulated by the SFC*.

14.5 Key Issues Arising from Hong Kong’s Experience with Demutualization

The following paragraphs describe some of the main areas of difficulty which were encountered during Hong Kong’s demutualization. These provide some flavour of the regulatory questions which may arise in other jurisdictions and recommendations as to issues to be considered during the demutualization process.

² The procedures put in place in this area are described in Chapter 5 on Hong Kong’s framework for dealing conflicts of interest (p. 87) (Part III of the SFC’s chapter dealing with conflicts of interest which has been prepared for this course).

14.5.1 Extent of Regulatory Control Over Exchanges/Clearing Houses Fees and Charges

Consider the competition laws/authority, the competitive environment of the exchange/clearing house, the scope of approval if applicable and factors to consider for approval, and control over exchange/clearing house budget. In a freely competitive market with a competition authority, regulatory involvement may be unnecessary (but Hong Kong lacks a competition authority and the exchange has exclusive rights to operate a stock market in Hong Kong).

14.5.2 Preparation of Accounts as Necessary for a Public Company

Practices of private or mutual bodies are likely to raise or reveal many issues. It is necessary to begin the work early to avoid surprises and resolve issues well ahead of listing.

14.5.3 Issues Unique to a Company Limited by Guarantee

Hong Kong and Australia's experience was that there was no legal mechanism for conversion of a company limited by guarantee (being the corporate structure of ASX and HKSCC before their respective demutualizations) to a company limited by shares. This was addressed in both countries by new statutory provisions.

14.5.4 Governance and Public Interest Duties

Consider whether any pre-existing public interest duties should be expanded (in Hong Kong, the exchanges' duties were expanded to the HKEx holding company level). Consider whether changes should be made to the governance structure (in Hong Kong there was concern over achieving a diverse shareholder base leading to government appointment of 50% of the HKEx board but to be phased down over time).

14.5.5 Risk Management

Consider the need for increased regulatory involvement and maintaining value added participation by market players. The regulator may wish to have a say if there is any proposal to reduce/vary risk management reserves. The new governance structure may exclude

market participant specialists who are themselves at risk to exchange/clearing house operations and have a strong self interest in maintaining state of the art risk management (in Hong Kong they participate instead via consultative committees).

14.5.6 Conflicts of Interest

Consider having the statutory regulator make all listing decisions where the exchange/clearing house or holding company lists on itself or an affiliate. Secondly, consider conflicts of interest of the listed group where it may make decisions affecting its competitors or business associates (including listing, admission, service provision, pricing). New provisions may be appropriate depending on the competitive environment, adequacy of competition laws and pre-existing regulatory powers. Consider an MOU for conflict identification, recording/auditing, resolution (e.g., statutory regulator may make the decision in appropriate circumstances).

14.5.7 Revised Allocation of Regulatory Functions

Consider whether the demutualized exchange will continue to have a commitment to any pre-existing self-regulation and if self-regulation is to continue whether new arrangements are necessary to reinforce this. If regulatory functions are to be reallocated, consider the need for an MOU and begin work early to ensure smooth transition. Will the demutualized exchange be willing to give up a function if it means giving up control over a material source of income (e.g. over the number of new companies coming to listing)?

14.5.8 Ownership Restrictions

Consider whether ownership restrictions should apply to the listed body or its exchange/clearing house affiliates. This may affect valuation and have governance implications.

14.5.9 Auditing of Financial Condition of SRO

If financial intermediaries are routinely audited, query why an exchange also should not be required to meet specified capital or other financial requirements.

APPENDIX 1:

Summary of the Exchanges and Clearing Houses (Merger) Ordinance

This Appendix contains a summary of the *Exchanges and Clearing Houses (Merger) Ordinance* which was enacted in February 2000 just a week or two prior to implementation of the demutualization and merger in March 2000.

Recognition of Exchange Controller

Section 3 prohibits a person from being the controller of an exchange company or clearing house unless the person is a recognized exchange controller (REC). A controller is defined to include, among others, any person who either alone or with any associates controls the exercise of more than 35% of the voting power at any general meeting of the company. The Commission may recognize a person as a REC and attach conditions to such recognition. The Financial Secretary may exempt persons from the recognition requirement. A contravention of section 3 or failure to comply with a condition to recognition is an offence. The Bill also specifies that HKEx shall be deemed to be a REC on commencement of the ordinance.

Section 4 provides for withdrawal of recognition of a REC by the Commission. Section 5 provides that the interest of a REC in an exchange or clearing house cannot be increased or decreased except with the approval of the Commission.

Person Not to Become Minority Controller

Section 6 provides that a person shall not become a minority controller of a REC or any exchange company or clearing house except with the approval of the Commission in consultation with the Financial Secretary. A minority controller is defined to include a person who either alone or with any associates is entitled to exercise 5% or more of the voting power at any general meeting of the company. The Commission can attach conditions to the approval of a minority controller. A contravention of section 6 or failure to comply with a condition to approval is an offence.

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Duty to Ensure Fair and Orderly Market, Etc.

Section 8 imposes duties on a REC and an exchange company to ensure fair and orderly markets. It also imposes duties on a REC and a clearing house to manage risks prudently. In performing these duties the relevant bodies must act in the interests of the public, having particular regard to the interests of the investing public. These public interest duties prevail over any other interests the body is required to serve. A no liability provision applies for the good faith performance of section 8 duties.

Section 9 requires the REC to establish a risk management committee to formulate risk management policies for consideration by the REC's Board. The Financial Secretary may appoint five of the seven members of the risk management committee and HKEx may appoint two, one of whom must be a shareholder elected director of HKEx.

Section 10 requires that the rules and amendments to the constitution of a REC must be approved by the Commission. Section 11 requires the chairman of an REC to be approved by the HKSAR Chief Executive. Section 12 requires the CEO and COO of a REC to be approved by the Commission.

Provision Where REC Seeks to be Listed Company

Section 13 requires the Commission to make rules and arrangements to avoid conflicts of interest where an REC or its subsidiaries seeks to be a listed company. This would include rules providing for the Commission to make listing rules decisions—and to receive related fees—in relation to a REC that seeks listing or is listed. Section 14 enables the Commission to give directions to a REC to remedy any conflicts of interest.

Fees to be Approved By Commission

Section 14 provides that no fee of a REC or its subsidiary exchange or clearing house can have effect unless the fee is specified in the body's rules and approved by the commission. In considering such fees, the commission must have regard to: (1) the level of competition, if any, in Hong Kong for the matter for which the fee is imposed, and (2) the level of fee, if any, imposed by other exchanges and clearing houses in or

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outside Hong Kong for the same or similar matter to which such fee relates.

Section 20 enables the Financial Secretary to appoint not more than eight persons to the Board of HKEx. HKEx will have an initial Board of 15 directors. From the HKEx annual general meeting in 2003, the Financial Secretary can appoint no more Board members than those elected by the HKEx shareholders.

Section 22 provides for the conversion of Hong Kong Securities Clearing Company (HKSCC) from a company limited by guarantee to a company limited by shares. This is done by special resolution of HKSCC approved by the Commission.

Section 23 provides that members of the exchanges who are registered dealers on the commencement date are deemed to be exchange participants of the exchanges.

Consequential Amendments

Schedule 1 provides a variety of remedial measures where a person has violated the exchange controller or minority controller sections 3, 4, or 6. These include freezing shares, restricting voting rights, and court-ordered sale of shares.

Schedules 2 and 3 provide for persons to be deemed to be, or not to be, associates for the purposes of sections 3 and 6, and for persons to be deemed not to be exchange controllers or minority controllers (e.g., a recognized clearing house).

Throughout the eleven *Hong Kong Securities and Futures Ordinances* references to members of the exchanges have been changed to “exchange participants.”

The Commission's additional powers to issue restriction notices and suspension orders to an exchange or clearing house (sections 50 and 51 of the *SFC Ordinance*) have been extended to apply to an REC.

HKEx is specified as a public body under the *Prevention of Bribery Ordinance*.

Definitions of “trading right” have been added to the *Securities Ordinance* and the *Commodities Trading Ordinance*. The compensation fund provisions of these ordinances have been amended to require compensation fund deposits from holders of trading rights instead of

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exchange members/shareholders and allowing claims for compensation to be made against exchange participants.

Qualification requirements for exchange members under the *Securities Ordinance* and the *Commodities Trading Ordinance* have been deleted (e.g., requirements to be registered dealers engaged in the sole business of dealing in Hong Kong).

A requirement that the exchange enforce compliance with the Financial Resources Rules has been deleted (since this function was transferred to the Securities and Futures Commission).