

# **Demutualisation, Merger and Listing**

## **The Hong Kong Experience**

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## **A. Introduction**

Records of securities trading in Hong Kong date back to 1866 around the street corner in the heart of the present central business district. The first formal stock market was established in 1891. During the period between the two world wars, a second exchange was formed. The two exchanges merged after the Second World War to form the Hong Kong Stock Exchange in 1947. The rapid growth of the Hong Kong economy led to the breakdown of the old tradition that stocks were investment vehicles reserved for the rich and elite upper class in the late 1960's. The other stock exchanges were formed between 1969 and 1972 – the Far East Exchange, the Kam Ngan Stock Exchange and the Kowloon Stock Exchange. There were neither securities laws nor rules and regulations governing the operations of a stock exchange at that time.

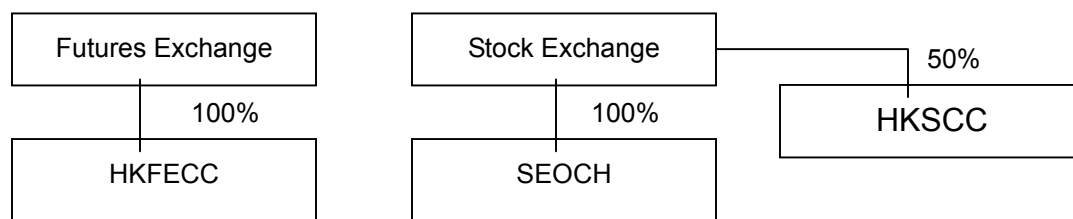
Prompted by the 1973 market crash and the need to strengthen market surveillance, the Hong Kong Government set up a working party in 1977 to consider the unification of the four stock exchanges. As a result, the unified exchange or the Stock Exchange of Hong Kong, or SEHK, commenced business in April 1986. It was an arduous task for the then Hong Kong Government to push for the unification of the four exchanges. A condition of the merger was that every seat in each of the four former exchanges was given a seat in the Stock Exchange of Hong Kong. Another condition was that the unified stock exchange could not create any new membership. The total number of seats was 929, which explained why we had a large number of seats in the Stock Exchange of Hong Kong.

The Hong Kong Futures Exchange or HKFE was formerly the Hong Kong Commodities Exchange. It was established in 1976 and was an exchange for the trading of futures contracts of cotton, soy beans and a few other commodities. However, as Hong Kong had never been a commodities trading centre and, in particular, garment producers that needed to hedge their position found that they were better off hedging their raw material costs in Chicago, turnover in the Futures Exchange was generally low. Around the time of the unification of the four stock exchanges, Hong Kong Futures Exchange launched a new product, the Hang Seng Index Futures or the HSI Futures. It was a big success. It turned out that this single product is still the most actively traded product on our derivatives market trading. However, the risk management technique of the Hong Kong Futures Exchange at that time was primitive and could not face the stringent test when worldwide stock markets collapsed in October 1997. Hong Kong market was the only one which had to close for 4 days in order to provide for a lifeboat arrangement so that the obligations of the Futures Exchange Clearing House could be honoured.

After the stock market crash in October 1987, the Stock Exchange underwent fundamental reforms, including the establishment of more widely representative councils and strong, professional executive management teams, to safeguard the interests of all market participants and investors to operate and develop both markets effectively. The clearing house of the Hong Kong Futures Exchange also underwent major reforms in order to better cope with market risks. As can be seen, the history of the development of the securities and derivatives market in Hong Kong has long been marked by mergers and reforms. Looking back, the regulatory reform stimulated by the crash of 1987 set Hong Kong on the path to becoming a major financial centre.

## B. Pre-Merger Period – 2 Exchanges & 3 Clearing Houses

### Separate Operating Entities Before the Merger



Between 1986 and the merger of the various entities in 2000, the stock market, the futures market and the clearing houses in Hong Kong were established separately and operated as follows:-

### 1. The Stock Exchange of Hong Kong Limited ("SEHK")

As stated above, the SEHK commenced business in April 1986 following the merger of the then four stock exchanges in Hong Kong. It was established as a front-line, self regulatory organisation under a piece of law known as the Stock Exchanges Unification Ordinance. Under the Ordinance, the SEHK operates as a monopoly as it is the only exchange company recognised by the Hong Kong Government to establish, operate and maintain a stock market in Hong Kong.

The SEHK was incorporated under the Companies Ordinance in Hong Kong in the form of share capital. The authorised share capital was HK\$1,200 divided into 1,200 "A" shares of HK\$1 each. It was owned by its member brokers who were required to hold at least one "A" share, which conferred membership and, thus, trading privileges. Each "A" share carried the right of one membership in the Stock Exchange. There were all along 929 shares outstanding held by registered dealers who operated stockbroking firms. The number is the same as the total number of seats of the four former stock exchanges before the merger in 1988. New entrants to the securities business in Hong Kong must acquire a seat or a membership from an existing member. Like other membership organisations, the limited supply of membership created a value for the seats. The SEHK was governed by a Council, with the majority of the Council members being broker members of SEHK.

### 2. Hong Kong Futures Exchange Limited ("HKFE")

As stated earlier, the HKFE was established in 1976 and was licensed by the Government as the exchange company to establish and operate the commodity exchange in Hong Kong under the Commodities Trading Ordinance. The Futures Exchange had approximately 135 members and it was governed by a board which consisted of 12 members who were either representatives of HKFE members or independent persons.

### 3. Hong Kong Securities Clearing Company Limited ("HKSCC")

HKSCC is a Hong Kong company limited by guarantee and was owned 50% by the SEHK; the remaining 50% was held by a number of commercial banks. All members of the SEHK must be participants of the HKSCC. It operates the Central Clearing and Settlement System (CCASS) for transactions concluded at the SEHK. It also operates a depository providing custody and nominee services, and a registrar company.

For SEHK transactions, the HKSCC operates a Continuous Net Settlement (CNS) system in which it acts as the settlement counterparty to trades among Stock Exchange members. It also facilitates the settlement of transactions between brokers and custodians.

4. HKFE Clearing Corporation Limited ("HKFECC")

HKFECC is a wholly owned subsidiary of the HKFE and it also acts as the clearing house to the HKFE. It is the settlement counterparty to all HKFE contracts.

5. SEHK Options Clearing House Limited ("SEOCH")

SEOCH is a wholly-owned subsidiary of the SEHK established to serve as the stock options market's clearing house. It acted as the counterparty to options trades with its members, calculates and collects margins, pays and collects options premia, and processes exercises and related settlements.

### C. **Merger and Proposal**

Only gradual and moderate reforms took place in the securities and futures market after the stock market crash in 1987. However, Hong Kong soon learnt that it must respond proactively to secure its leadership within the region and to reinforce its position as a global financial centre. Against this background and, in particular, in response to the Asian Financial Crisis that occurred in October 1997, the Financial Secretary announced in his Budget Speech on 3rd March 1999 a comprehensive market reform for the securities and futures market to enhance its competitiveness so as to meet the challenges of an increasingly globalised market place driven by the advancement of technology and the emergence of a growing population of sophisticated investors.

A proposed market structure was announced by the Hong Kong government in July 1999. The reform that took place included fundamental changes in the securities and futures regime by way of demutualisation and merger of the 2 exchanges and 3 clearing houses mentioned earlier into a single holding company, the **Hong Kong Exchanges and Clearing Limited** (the "HKEx"). The then existing members of the two exchanges approved the demutualisation and the merger in September 1999. The merger required the approval of the stock brokers and futures brokers, who were also shareholders, of the respective exchanges. A proposal was put forward in that each share of the former exchanges would be exchanged for one trading right of the cash or futures market of the new entity plus a certain number of shares which would be traded on the Hong Kong Stock Exchange. In addition, members could sell their shares to the new company at a price.

The proposal turned out to be a win-win situation for all members.

## **D. Reasons For the Merger**

The demutualisation and merger of the various exchanges and clearing houses in Hong Kong were necessary and imminent under the circumstances because of a number of factors and they include:-

### 1. Global Evolution

Exchanges around the world have been continuously undergoing reform because of the rapid evolution of the global securities and futures industry, the fierce competition faced by exchanges among themselves, and also, from independent trading systems which bypass traditional exchanges. National boundaries are no longer hurdles to the flow of funds and manpower. As technology advances, investments and businesses migrate to those markets with high transparency and liquidity, low transaction costs, diversified product base, sound regulation, high quality of service and robust infrastructure.

### 2. Trends of Integration

Exchanges worldwide are rethinking their strategies and operations to improve their services, reinforce their competitive positions and optimise their performance. Overseas, markets are rapidly integrating vertically (e.g. linking together trading, clearing and settlement functions into a single transaction chain) and horizontally (e.g. combining securities and futures products into a single organisation) and developing alliances with other exchanges.

### 3. Competition on Trading

Further, as financial markets become more globalised and investors become more sophisticated, competition from further afield has also become an increasing challenge. Stocks of major listed companies on the Hong Kong Stock Exchange could be traded easily in London and, increasingly, also in New York even in the past few years. Financial and equity based derivatives are even less geographically bound and fierce international competition in this area can already be seen.

### 4. Technological Advances

Technological advances have led to significant changes in the landscape of both "on-exchange" and "off-exchange" transactions. Such technology improvements have lowered the entry barriers to establishing new exchanges, thus, enabling a widespread emergence of alternative and proprietary trading systems whereby trades were executed off traditional exchanges in recent years. It can be seen that the new breed of electronic communication networks or "ECNs" in stock markets that have emerged have already siphoned an unknown amount of securities trading from traditional markets and intermediaries.

## 5. Opening Up of Markets

More governments and securities authorities are progressively opening up their national markets in order to attract international participation. They are beginning to understand that open door policies will improve the standard of the markets by making them more competitive and efficient, attracting larger and more diverse investors base and, at the same time, allowing for knowledge and skills to be transferred to the local markets.

## 6. Pressure from Investors and Financial Services Sector

Institutional investors and large, proprietary trading operations of investment banks and securities firms have become extremely powerful and more globalised. They are diversifying their trading through various markets and trading facilities so as to minimise transaction costs and increase liquidity. Thus competition among existing exchanges are keen. Also, demands from investors to have direct access to stock exchanges and representation in their governance prosper the growth of the alternative and proprietary systems.

## 7. Inherent Characteristics of Membership Organisation

As the demands of the capital market have changed, Hong Kong's old model of securities and futures market prior to the merger was progressively less suited to cope with the complex and competitive global environment. The old system also had a number of inherent problems. It could be seen from the structure earlier mentioned that the stock market and the futures market were both owned by their broker members and, thus, the development of both exchanges was subject to the interests of their respective members who were their shareholders. Although the two exchanges could not distribute their profits to their respective members, interests of broker members may not necessarily coincide with those of both exchanges that conduct business as a market operator in the Hong Kong financial markets. Profit maximisation was usually not a top priority item on the agenda for both exchanges. In a place where natural resources are almost nil, the importance of the financial services sector, including the securities and futures market, cannot be ignored. There is an issue of public interest here.

## 8. Conflicting Roles and Fragmented Market Structure

Also, before the merger of the exchanges, the two Exchanges performed four different roles (market operator, membership association, regulator and public body) that, sometimes in practice, conflicted with one another, compromised their conduct and, to a certain extent, impaired their overall performance. The growth of the securities market was impeded by restrictions on access, including the maximum number of trading seats available. Shortcomings in the co-operation between the two Exchanges led to overlapping, as well as gaps, between the products and services offered by them. In addition, Hong Kong's capital market infrastructure had been functionally rather fragmented, with a securities transaction involving multiple procedures and parties, and, often, necessitating

multiple systems and counterparty interfaces. This was inefficient and increased the risks and, in particular, systemic risks involved.

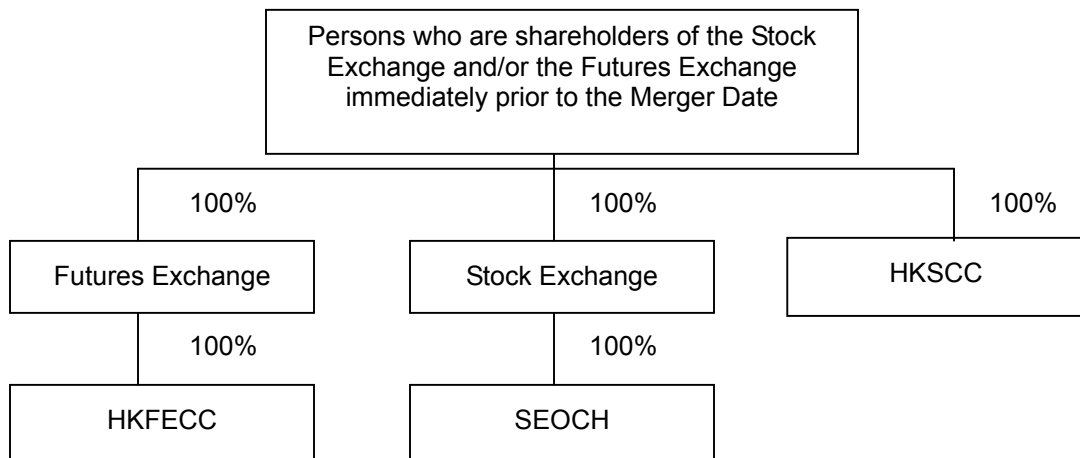
## 9. Rationalisation in Technology

Because of historical development, there has been diversity in the use of technology. Merger of the various entities provides opportunities and synergy to seek for certain standardisation in order to save maintenance and upgrading costs. There is potential for further integration of technological platform. For example, the Traded Options, which used to be a product of the Stock Exchange, has its trading system migrated to the Futures Exchange Trading System on 8th August 2001. Upgrading of other systems is under consideration and will have regard to both the cash and derivatives markets in mind.

## E. **Market Reform**

### 1. New Structure

The demutualisation and merger of the stock and futures exchanges and their clearing houses became a reality in March 2000. The market reform required that the SEHK to become a wholly owned subsidiary of HKEx; at the same time, the HKFE and the HKSCC also to become the wholly owned subsidiaries of HKEx. The new integrated exchange, **the Hong Kong Exchanges and Clearing Limited**, was finally established on 6th March 2000 pursuant to a new piece of legislation, the Exchanges and Clearing Houses (Merger) Ordinance. The corporate structure of the HKEx Group (ignoring nominee interests), immediately following implementation of the overall proposal, is as follows:-



It was believed that the success of the reform depended largely on the creation of an appropriate framework in which the new consolidated entity, HKEx operates. That framework must enable HKEx to pursue efficiently its profit-driven commercial goals on the one hand and effectively perform its public functions on the other. The framework is also expected to enhance HKEx to reinforce Hong Kong's position as a global financial centre. Various checks and balances were

also built in the proposed framework of HKEx whereby different public interests vested in it, as the sole operator of the securities and futures market of Hong Kong, were safeguarded.

Immediately upon occurrence of the merger, members of both exchanges exchanged their shares in the respective exchanges for shares in HKEx. Each SEHK share and HKFE share was cancelled in exchange for 800,000 and 1.4 million shares of HKEx respectively. Authorisations to trade on or through the facilities of both Exchanges were unaffected by the new arrangements and shareholders of both exchanges, who were trading members immediately prior to the merger, automatically became SEHK and HKFE Participants accordingly. Taking into account that there were 929 SEHK shares and 230 HKFE shares, the consideration represents an exchange ratio between the SEHK and HKFE members of 70:30 respectively. Since the HKSCC is a company limited by guarantee which has no issued shares and, thus, no financial value in the membership, its members have not received any allocation of shares in HKEx in respect of the HKSCC.

In addition, the HKEx Board determined to establish a moratorium on the issue of new Trading Rights (except for those rights that may be issued in respect of alliances with other stock exchanges or futures exchanges) for a period of two years from the date of the merger. For a further period of two years after the merger, no new Trading Rights will be issued for less than HK\$3 million per SEHK Trading Right or for less than HK\$1.5 million per HKFE Trading Right. New Trading Rights issued by HKEx (other than those automatically conferred on SEHK shareholders and HKFE shareholders on the date of the merger) will not be transferable.

## 2. Listing of HKEx

HKEx was subsequently listed on its own marketplace three months later on 27th June 2000. The then existing members of both exchanges were offered the opportunity to receive cash i.e. HK\$3.88 per each share of HKEx, in place of some or all of the shares in HKEx to which they were entitled, subject to the overall aggregate limits on the amount of cash being made available respectively to the members of the two exchanges. The overall aggregate limits for the SEHK and the HKFE are HK\$935.2 million and HK\$400.8 million, respectively.

In Hong Kong, the SEHK has been the front line regulator responsible for the approval of listing of companies. In this instance, there was a conflict of interest, or at least, a perceived one, between HKEx' intention to list on its subsidiary and the approval thereof, though such approvals are normally given by a committee independent of the management and shareholders of HKEx. Accordingly, the Securities and Futures Commission (the "SFC") took up the processing and handling of the HKEx' listing application, like the Hong Kong Exchanges handling all other listing applications. At the time of listing, HKEx' shares attracted wide interest from retail and institutional investors. The highest market price of HK\$18.95 for Hong Kong Exchanges was more than four times its valuation during the demutualisation and merger. Its market capitalisation was HK\$18.6 billion and its P/E ratio (based on 1999 earnings) was 35.8 times at the time of listing.

During all of last year, HKEx went through an organisational restructuring to streamline and integrate its business and support functions. Hence, the total number of staff for all the organisations was reduced from 1050 to the current level of 860. The initial integration phase, involving most of the operations, was completed by the end of last year.

### 3. Board of HKEx and Clearing

The Board of the HKEx has been entrusted to shape policies on major strategic, financial, regulatory, risk management, commercial and operation issues. The size of the HKEx Board is not big; it comprises only 15 directors, of which 14 are non-executive in nature. Out of the 14 Non-executive Directors, 8 were appointed by the Financial Secretary of the Hong Kong SAR Government to be "Public Interests Directors" i.e. to serve the interests of the investing public or the public interest. The rest of the 6 other directors are labeled "Shareholders Return Directors" and they are entrusted to serve the shareholders of the HKEx. It is believed that such a board size and composition facilitate discussions and decision-making, minimise the need for sub-committees and leave the operational and commercial execution role to the management.

### 4. Business Perspective

Although HKEx is required to perform its public functions, shareholders interests also need to be served. In view of the profit driven nature of the organisation, 5 different Business Units have been set up within HKEx to pursue different business goals and implement various business strategies. In this regard, all Business Units have taken proactive roles in promoting various services and products offered by respective units of HKEx to existing and potential market practitioners and users. In this regard, the Cash Business Unit has introduced a number of tradable cash products, in particular, the Exchange Traded Funds. Currently, the Tracker Fund of the Hong Kong Government and two iShares that track the indices of Taiwan and Korean stocks are all such funds being traded on the Hong Kong Stock Exchange.

As for the Derivatives Business Unit, it has facilitated the trading of Hong Kong Interbank Offered Rate (HIBOR) Futures Strips since September, 2000. Such kind of trading enables market participants to trade consecutive futures contracts in a single transaction. Also, trading of a smaller HSI Futures, known as mini-HSI Futures, was also introduced.

There is also an E-Business and Information Services Unit that offers various services to information vendors. This can be said to be a new business unit that was created after the merger in view of the prosperous electronic businesses. The Unit introduced an Internet "Framing Quotation Service" in December 2000 that allowed Exchange Participants and other website operators to offer stock quotation services on their websites without the burden of taking up the business and technical commitments as an authorised information vendor. The Unit has also been working with some TV operators to offer an On-screen Ticker Display on television screens.

## **F. Conclusion**

To conclude, maintaining the status quo was not an option for Hong Kong. Exchanges around the world are being forced to adopt new performance-driven organisations to launch upon a path of transformation. Strategies to compete and survive are represented by a host of demutualisations, public offerings, mergers of cash and derivative markets and clearing operations, and newly forged cross-border alliances. In short, exchanges are becoming increasingly client- and profit-driven business organisations in order to sharpen their appeal to users. HKEx is not alone.

Without such reforms as described, the Hong Kong securities and futures industry will not be able to maintain its competitiveness and face global challenges. This will also adversely impact on the broader interests of the economy and Hong Kong's status as a regional and an international financial centre.

Meanwhile, the Hong Kong SAR 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 investor and public interests.

Thank you.