Updating Your Study Manual

Instructions for Inserting Version 1.4

The followings serve as the instructions for updating **Topic 4: Dealing in Securities Traded on the Stock Exchange of Hong Kong** of Study Manual 2 for the Licensing Examination for Securities and Futures Intermediaries. Please be reminded that only the updated sections are provided for downloading. You may replace the relevant sections with this updated version for the study manual you possess.

Instructions:

1. Download and print out the following pages.
2. **Remove** the original front page and **Insert** the updated front page.
3. **Remove** pages 4-1 to 4-4 and **Insert** new pages 4-1 to 4-4.
4. **Remove** pages 4-15 to 4-18 and **Insert** new pages 4-15 to 4-18.

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HONG KONG SECURITIES INSTITUTE
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STUDY MANUAL FOR

PAPER 2
REGULATION OF SECURITIES

of

The Licensing Examination
for Securities and Futures Intermediaries

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Topic overview

This topic is devoted to a review of dealing in securities traded on the SEHK, apart from traded options which are covered in topic 7.

We shall begin by providing an overview of the types of intermediaries conducting the business of dealing in SEHK products. We shall then describe the exchange participant and trading right concept.

The topic provides a general description of the products traded on the SEHK and the Growth Enterprise Market (‘GEM’). We then take a look at the basic characteristics of the securities listed on the Main Board and the GEM.

The topic will also include a description of the trading mechanism and rules of the SEHK, including the trading system – the third-generation Automatic Order Matching and Execution System (AMS/3).

Hand-in-hand with trading is the clearing and settlement process. The reader will be given an overview of the process, including the operation as well as the relevant rules governing clearing and settlement, to complete their knowledge of the trading cycle.

We shall then give an overview of the SEHK disciplinary procedures.

Finally the cost of trading for an investor will be outlined so that intermediaries can appropriately advise their clients.

Learning outcomes

At the end of this topic the reader should be able to:

(a) explain the requirements governing exchange participantship and stock exchange trading rights;

(b) know the basics about the products – equity, debt, unit trusts/mutual funds, exchange traded funds, equity linked instruments, warrants and listing;

(c) describe the trading rules and third generation of the Automatic Order Matching and Execution System (AMS/3);

(d) know the implications of trading suspension;

(e) understand the clearing services and settlement services, including securities settlement and money settlement;

(f) know the disciplinary procedures of the SEHK; and

(g) know the categories and rates of transaction costs for an investor.

1 Intermediaries trading in the Hong Kong securities market

1.1 The Hong Kong market is one of the preferred locations in the Asian time zone for international and domestic investors. The SFC and the HKEx aim to provide foreign investors with convenient access to the market, facilitating cross-border trades.

1.2 Trading in products listed on the SEHK is not limited to SEHK participants. Intermediaries conducting the business of dealing in securities which are SEHK products include:

- exchange participants (SEHK participants). They are subject to the licensing requirements of the SFC;
- intermediaries that are subsidiaries of (or controlled by) foreign firms having a business presence in Hong Kong. They may or may not be SEHK participants. They are subject to the licensing requirements of the SFC; and
- overseas intermediaries that do not have a physical presence in Hong Kong. They trade in SEHK products through the above. They are not subject to the licensing requirements of the SFC since they do not have a physical presence here.

The Hong Kong Exchanges and Clearing Limited

1.3 The Hong Kong Exchanges and Clearing Limited (‘HKEx’) is a company listed on the SEHK and is an exchange controller as defined in the SFO. HKEx controls and has as subsidiaries the exchanges and clearing houses in Hong Kong.

1.4 HKEx regulates listed companies, trading on the exchanges, and the related clearing and settlement functions. The regulation of intermediaries engaged in trading on the exchanges and their relationships with each other and their clients are principally directly regulated by the SFC. Accordingly, although the operating and other rules are extensive, *the regulatory aspects of the operations of the HKEx group are limited in their scope.*

1.5 There are two exchanges:

- the Stock Exchange of Hong Kong Limited (‘SEHK’), which provides for trading in securities as defined earlier on two boards, the Main Board and the Growth Enterprise Market (‘GEM’), and in options on underlying securities also traded on the Main Board; and

- the Hong Kong Futures Exchange Limited ('HKFE'), which provides for trading in futures contracts, principally financial futures.

1.6 There are three clearing houses:

- the Hong Kong Securities Clearing Company Limited ('HKSCC'), which was an independent corporation and the clearing house for the 'cash business' of the SEHK; the HKSCC operates the Central Clearing and Settlement System ('CCASS');
- the SEHK Options Clearing House Limited ('SEOCH'), a wholly owned subsidiary of the SEHK, which clears the traded options business of the SEHK; and
- the HKFE Clearing Corporation Limited ('HKCC'), a subsidiary of the HKFE which clears the futures business of the HKFE.

1.7 CCASS is operated by the HKSCC for securities transactions on the SEHK. HKEx intends to separate derivatives from cash instruments by installing clearing and settlement through a new derivatives clearing and settlement system. Since this new system is not yet implemented we shall make no further reference to it in this Study Manual.

2 SEHK exchange participants and trading rights

Participants – general

2.1 The SEHK rules define an exchange participant as a person who, in accordance with the exchange rules, may trade on or through the exchange and whose name is entered in a register as a person who may trade on or through the exchange.

2.2 There are a number of groups of 'participants' within the structure of the various exchanges and clearing houses. Membership of HKEx is distinct from access to the trading facilities of the SEHK and HKFE and access to the settlement facilities of the HKSCC, SEOCH and HKCC. Because of the separation of ownership and the right to trade, membership (in the sense of ownership of a share in HKEx) is no longer needed to trade on the exchanges or to clear the trades.

2.3 Instead, those who wish to trade through the exchanges ('exchange participants') are required to hold trading rights and to register with the SEHK as (SEHK) exchange participants, or with the HKFE as (HKFE) exchange participants, depending on whether they wish to deal in securities (including options on stocks) or in futures contracts. Trading rights are transferable subject to the approval of the Board. Those wishing to clear trades must become clearing participants of the respective clearing houses.

2.4 The various forms of participantship require the payment of appropriate deposits and subscriptions to the exchanges and clearing houses. The participantship confers upon the person the right to one trading terminal seat on the trading floor (and one off-floor) for every trading right it holds.

Note: for clarity, the term ‘SEHK participant’ may be used in this Study Manual instead of the term ‘exchange participant’.

2.5 From a regulatory point of view, SEHK participants must ensure that they are:

- licensed by the SFC for Type 1 activity;
- registered by the SEHK as holding the necessary participantship for the trading activities they wish to engage in on the SEHK; and/or
- registered by the HKSCC and/or SEOCH for the clearing activity they wish to engage in.

SEHK participants

2.6 An SEHK participant must be a corporate body[1]. It must comply with capital and liquid capital requirements and other fit and proper requirements, as discussed in other earlier topics.

2.7 The qualification requirements are as follows:

- be a holder of a stock exchange trading right;
- be licensed for Type 1 activity (and others, if appropriate) under the SFO;
- [deleted]
- be a corporation limited by shares and incorporated under the Companies Ordinance of Hong Kong;
- have fully paid-up ordinary share capital of:
  - if it provides securities margin financing, not less than HK$10 million; or
  - otherwise not less than HK$5 million;

[1] Dealing partnerships may operate for a period of two years from the implementation of the SFO — that is, 1 April 2003 — and must restructure as companies within 2 years from 1 April 2003.

- With trading terminals, participants use the traditional data entry and screen-based enquiry to get access to the market.
- Participants may opt for the open gateway approach, which is a network communications device installed at the participant's office to provide an electronic linkage between the trading system and the intermediary's trading system.
- Within the open gateway, participants may select from two separate systems that will act as its intermediary trading system: the multi-workstations system or the BSS.

Trading parameters

4.7 The trading parameters for AMS/3 are:

- for a limit order, the bid (ask) price is within the range of the best ask (bid) and not lower (higher) than 24 spreads of the best bid (ask) price;
- for an enhanced limit order, the ask price is 4 spreads lower than the current bid or the bid price 4 spreads higher than the current ask; and
- for a special limit order, there is no restriction on the limit price with respect to the best price on the other side of the market.

In addition:

- the maximum order size is 600 board lots per order;
- the maximum number of outstanding orders per participant is 4,000; and
- the maximum number of orders per price queue is 2,000.

Order types

4.8 There are a number of types of buy and sell orders which participants are called upon to execute for clients. These include:

- at-the-market orders;
- stop-loss orders;
- limit orders;
- enhanced limit orders;
- special limit orders;
- at-auction orders; and
- at-auction limit orders.

At-the-market order

4.9 An at-the-market order is an order to buy or sell shares at the best available price.

Stop-loss order

4.10 The primary function of a stop-loss order is to restrict the loss of investors. When the value of a security drops to a level pre-set by the investor, the investor may sell the security to limit his loss. However, the ability of an intermediary to execute the order for clients depends on factors such as the demand for the security in the market, the trading price at the time and the trading conditions.

Limit order

4.11 A limit order is an order in which the client sets a specific price at which the transaction may be executed; or at a better price if the participant is able to obtain it. The order limits the highest or lowest price of a transaction.

Enhanced limit order

4.12 An enhanced limit order is similar to a limit order except that it will allow matching of up to 5 price queues at the same time. The input order price of an enhanced limit order can be matched up to 4 spreads better than the best price on the other side of the market. Any unfilled quantity of such an order after matching will be converted into a limit order at the input order price.

Special limit order

4.13 A special limit matches up to 5 price queues (i.e. the best price queue and the next 4 queues each at one-spread away) as long as the traded price is not worse than the input limit price. Any unfilled quantity of a special limit order after matching will be cancelled by AMS/3.

At-auction orders

4.14 During the order-input period of a pre-opening session, participants are allowed to input at-auction orders and at-auction limit orders.

4.15 An *at-auction order* is a market order without a specified price. It enjoys a higher auction-matching priority than an at-auction limit order. It will be cancelled automatically after order matching.

4.16 An *at-auction limit order* is a limit order with a specified price. After order matching in the pre-opening session, unfilled at-auction limit orders with the input price not deviating nine times or more from the prevailing nominal price will be converted to a limit order at the input price and carried forward to the continuous trading session.

Non-automatched trades

4.17 Trades not done on AMS/3 must be reported to the SEHK, and information on these trades will be disseminated to the market. To ensure transparency, participants involved in the SEHK and investors must be given the opportunity to know the details of all trades, including non-automatched trades.

Quotation rules

4.18 The first bid or ask order entered into the trading system on each trading day is governed by the opening quotations rules.

4.19 The first order, if it is a bid, must be at a price higher than or equal to the previous closing price minus 24 spreads.

4.20 The first order, if it is an ask, must be at a price lower than or equal to the previous closing price plus 24 spreads.

4.21 The spread of a security depends on its share price:

Price Range (HK$)			Spread (HK$)
For all securities other than those specified by the SEHK and debt securities:			
0.01	-	0.25	0.001
>0.25	-	0.50	0.005
>0.50	-	2.00	0.010
>2.00	-	5.00	0.025
>5.00	-	100.00	0.050
>100.00	-	200.00	0.100
>200.00	-	500.00	0.200
>500.00	-	1,000.00	0.500
>1,000.00	-	2,000.00	1.000
>2,000.00	-	5,000.00	2.000
>5,000.00	-	9,995.00	5.000
Securities which are specified by the SEHK and all debt securities:			
0.50	-	9,999.95	0.050

4.22 The purpose of the quotation rules is to ensure that there is no sudden dramatic fluctuation in the share price, for the maintenance of orderly trading in the market.

Direct business (crossing of trades) rule

4.23 ‘Direct business cross trades’ means business transacted by an SEHK participant who acts for both the buyer and the seller, whether as principal or agent.

4.24 Every participant conducting direct business transactions within the pre-opening session and the trading hours must input details of such transactions into the system within 15 minutes after the conclusion of the transactions.

4.25 Direct business transactions conducted outside the pre-opening session and the trading hours must be reported within the first 15 minutes of the commencement of trading on the next trading session.

4.26 Direct business transactions once recorded by the system cannot be cancelled by the participant.

4.27 The price of every direct business transaction must be within the range of:

- the lowest of eight spreads below the previous closing price;
- the lowest bid and the lowest ask price up to the time of the transaction on the day;
- the highest of eight spreads above the previous closing price; and
- the highest bid and the highest ask price up to the time of the transaction on the day.

4.28 The focus of the rules is the prompt and accurate reporting of trades to ensure market transparency. Up-to-date information on the current trading activity is necessary so that the SEHK can be aware of unusual activity and, perhaps, improper trading.

4.29 Rules for outcry in the trading hall: Trades by open outcry are infrequent but are governed by some procedural rules. They must be made through the public address equipment provided by the SEHK and recorded by the SEHK on tape. Prices announced through an outcry must at all times follow the quotation rules of the SEHK.

5 Suspension of trading

5.1 The purpose of suspension of trading of a particular stock is to ensure a fair and orderly market, so that trading in the stock is undertaken on a fully informed basis and to avoid any uneven information dissemination and opportunities for insider dealing.

