HK FINANCIAL SERVICES DEVELOPMENT COUNCIL 香港金融發展局

Observations on Market Liquidity Enhancement

29 August 2022

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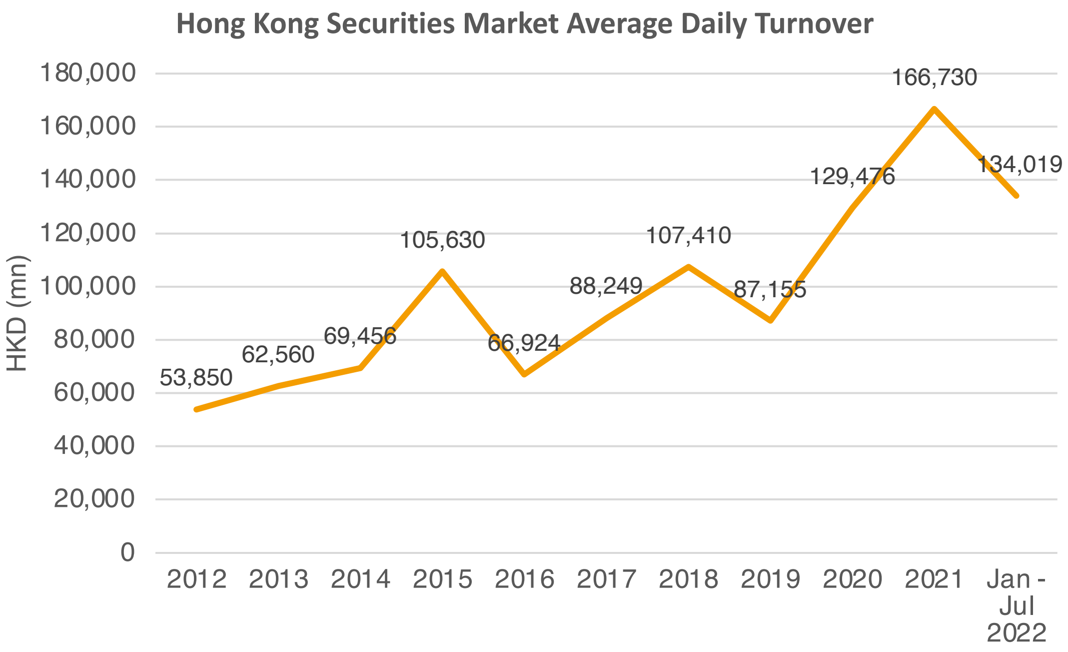
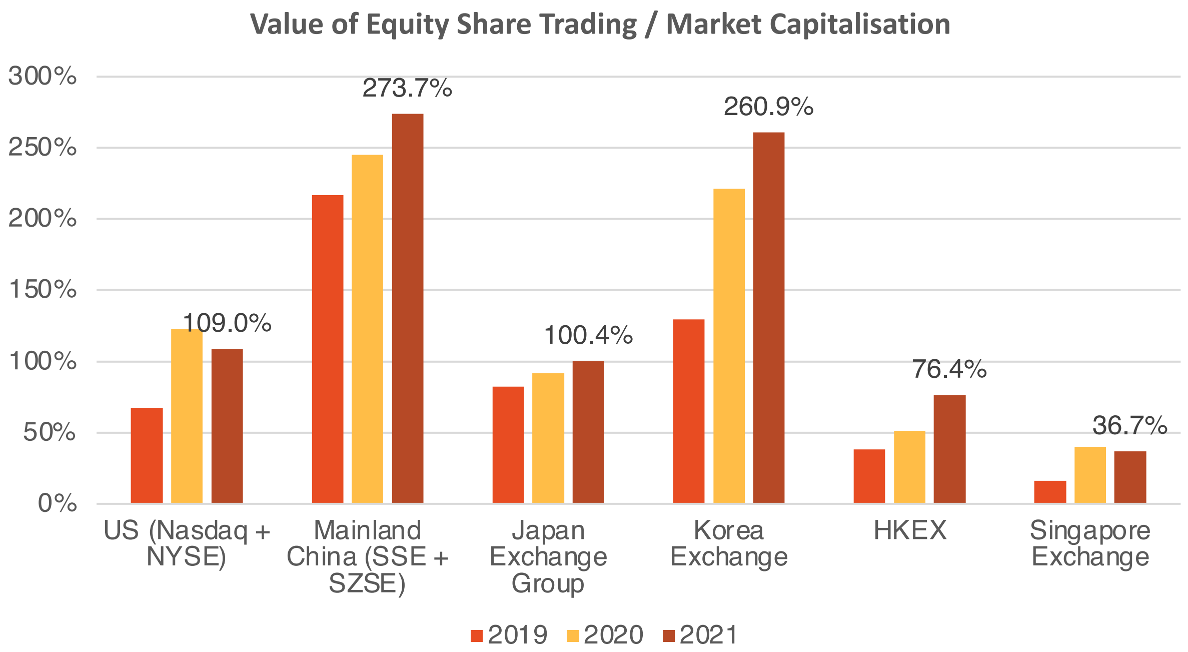
Background

Global Market Liquidity



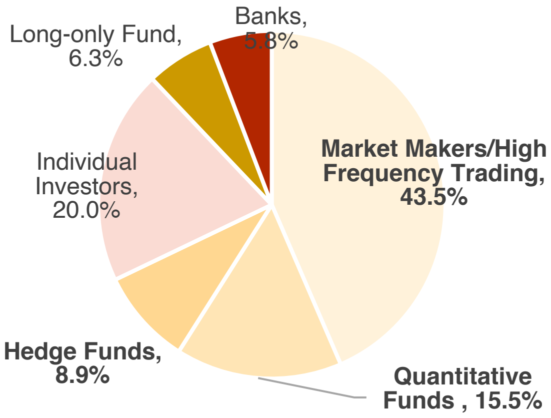


- Although the average daily turnover of HKEX has generally shown an upward trend over the past years, turnover velocity (value traded relative to the overall capitalisation), an indicator that reflects liquidity of a market, continues to be lagging other major exchanges globally.
- More specifically, **the turnover velocity of HKEX was at 76.4% in 2021, while that of other major exchanges tends to be well above 100%.**

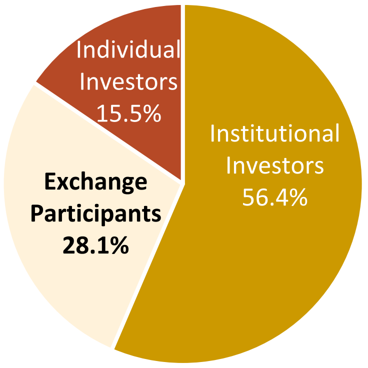
Source: HKEX; World Federation of Exchanges

Liquidity Providers

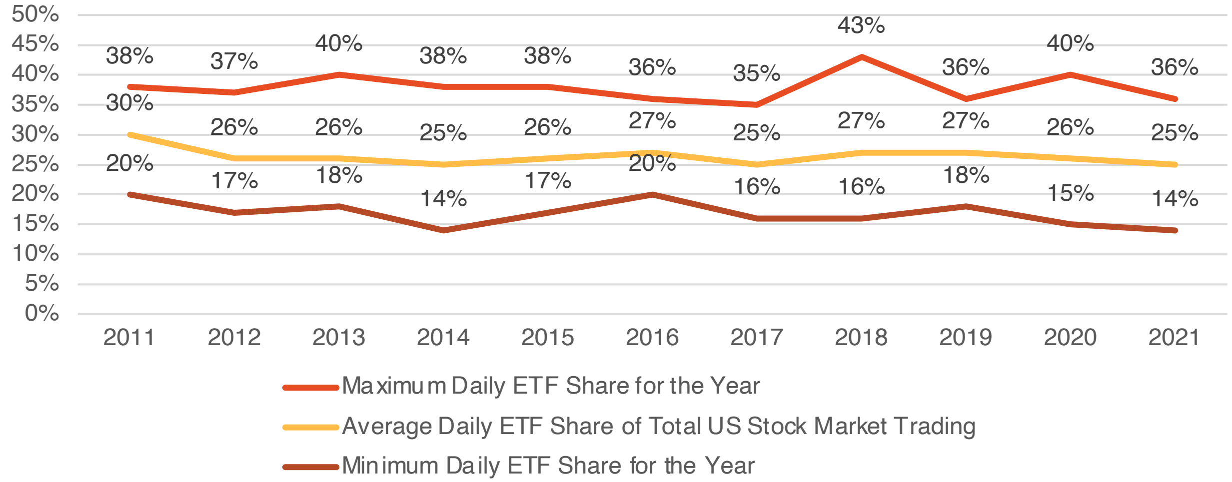
2020 US Market Turnover by Investor Types



2020 HKEX Cash Market Turnover by Investor Types



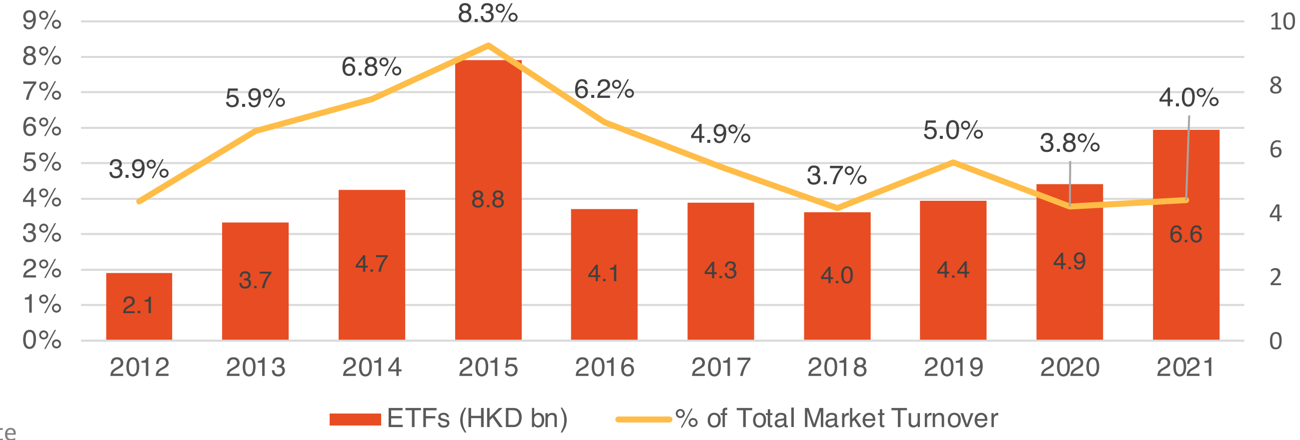
ETF Secondary Market Trading Averaged 25 Percent of Daily US Stock Trading in 2021



Market makers: Comparing the investor types of the US and Hong Kong markets, market turnover in the US is predominately contributed by market makers/high frequency traders, quantitative funds and hedge funds, who took up a total of **67.9% in 2020** and 65.9% in 2021. These market participants (roughly categorised as Exchanges Participants) only accounted for **28.1% of the market turnover in Hong Kong in 2020.**

ETFs: In general, ETFs are considered an attractive investment vehicle among investors due in part to its high liquidity characteristics. In 2021, ETFs accounted for about **25% of the total US stock trading** by volume. While a significant growth in turnover is observed in Hong Kong's ETF market in 2015, it was not sustained afterwards, with the average daily turnover staying at roughly **4% of the market total** in 2021.

ETFs as a Percentage of Overall Hong Kong Trading (2012 - 2021)



Source: Bloomberg Intelligence; HKEX; Bloomberg; Cboe Exchange, Inc.; Investment Company Institute

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Potential Measures to Enhance Market Liquidity

Enhancements of ETF trading activities

1	2	3	4
Introducing a new spread table with tick sizes more suitable for Hong Kong-listed stocks	**Increasing maximum spread range requirement to above 24 spreads**	**Extending the market maker short-sell permission for manual trades (OTC trades after-market hours)**	**Introducing adjustments to ETF settlement approaches**
Existing Challenges			

• The new spread table with reduced tick sizes introduced in 2020 is for ETFs and L&I Products* only
• Single stocks are traded with the old spread table:
  ▪ Investors have to pay higher spreads for single stocks trading
  ▪ ETF quotations are marked up to cover for the higher stock spreads
	• The current maximum spread range allowed for equities and ETFs is 24 spreads
	• This spread might not be significant enough for market markets to trade under certain market conditions, especially when the market becomes overly volatile
		• Market makers are unable to provide liquidity outside the continuous trading sessions with exemptions such as short selling, tick rule, stamp duty
		• This arrangement hinders their market making functions
			• On the ETF primary market, market makers are required
			a) to perform Free of Payment (FOP) settlement on T or T+1 for the creation orders, and
			b) obtain ETF units at T+2 through one of the four settlement batches
			• Resulting in higher costs and risks

Upon the Implementation of the Proposed Enhancements			
• Align with the latest market development • Reduce price spreads when market makers offer ETF pricing to investors • Lower trading costs for market participants • Enhance flexibility and price efficiency for investors when faced with various unexpected market conditions	• Increasing the maximum premium/ discount requirement to above 24 spreads under certain circumstances as appropriate, while other measures can be put in place to prohibit certain behaviour intended to disrupt market orders	• Allow further flexibility to the participant • Provide an alternative channel to generate profit • Provide more ETF liquidity during non-continuous hours • Improve ETF liquidity on the following days	• Settle ETFs through Delivery Versus Payment (DVP) can lead to better market liquidity than using FOP • Set clearer guidance and allow ETFs to settle through DVP on T+2, or through one batch of settlement at T+2 afternoon

*Leveraged and inverse products

Enhancements of general trading and clearing activities

1	2	3
Introducing new rules that allow market makers to engage multiple clearing participants	**Assessing portfolio risks of market participants across the central counterparties**	**Considering market maker programmes for illiquid stocks to improve liquidity**

Existing Challenges

1

- Each market maker in Hong Kong can only settle trades with one clearing participant (i.e. General Clearing Participant), which could result in high concentration risks

2

- While many investors hold portfolios across all three central counterparties, margins are calculated based on each of the portfolios held under the three CCPs separately, without any regard to the overall position held by an investor
- Create inefficiency in terms of capital usage, resulting in higher costs that limits the market makers' ability to provide liquidity in the market
- Pose higher inventory risk, especially at times when market are volatile

3

- In spite of existing incentive schemes offered to market makers by HKEX, such as discounted trading fee or 100% trading fee waiver or rebate, a significant number of securities remain relatively illiquid in the market

Upon the Implementation of the Proposed Enhancements

1

- Allow market makers to clear with multiple clearing participants (i.e. allowing a multiple-GCP system on the exchange level), with each clearing participant making required reporting
  - Reduce concentration risks
  - Provide market makers the flexibility to choose suitable clearing participants

2

- Assess portfolio risks of participants across CCPs to optimise capital efficiency for clearing and trading participants

3

- Considering market making incentives targeted at low-liquidity securities with practical standards

Upgrade of infrastructure and systems

Existing Challenges

Upon the Implementation of the Proposed Enhancements

1. Adopting an opt-in self-match prevention mechanism by the HKEX

Existing Challenges

- Many exchanges in both developed and emerging markets have adopted self-match prevention mechanisms to reduce unintentional, frictional and other transaction costs
- Currently, there are no self-match prevention mechanisms for equities on HKEX

Upon the Implementation of the Proposed Enhancements

- Considering international practices and Hong Kong's fundamental market structure to adopt an opt-in self-match prevention mechanism
- With reference to self-match prevention rules of other exchanges, such as those in the US and other markets

2. Providing more transparency on picked gateways connecting members and exchanges

Existing Challenges

- Information on which gateway(s) is(are) allocated during the time of trading through the matching engine is not transparent enough in Hong Kong

Upon the Implementation of the Proposed Enhancements

- Changes in three main areas:
  - Disclose more details on how the technical infrastructure is designed
  - Maintain a single first-in-first-out gateway with advanced time-stamping technology to minimise gaming of timing; and
  - Making available a single session per symbol-gateway switch for each client to reduce variability and prevent a race of infrastructure expenditure by sophisticated participants

3. Upgrading trading system with advanced technology accompanied with capacity building

Existing Challenges

- To keep up with changing client needs in the face of the constantly evolving technology landscape and stay relevant in the global competition.
- Compared with other major global exchanges, more proactive actions would be appreciated

Upon the Implementation of the Proposed Enhancements

- Continue to develop and upgrade its trading systems, preferably with the most advanced technology that supports optimal electronic mechanisms and infrastructure
- As such upgrades are incorporated, structure comprehensive and detailed capacity building plans for market participants and stakeholders
- Support them in making informed decisions and seizing opportunities that are less familiar with

Q&A

Thank you

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