

A public declaration of intent

By RORY NICHOLAS

The recent renaming of the Hongkong Commodity Exchange as the Hongkong Futures Exchange (HKFE) is significant and more than just a change in name.

It is a public declaration that the intense activity behind the scenes is transforming the exchange and it is also in line with current international practice which now more clearly defines futures trading.

Much has been done in the past 12 months by both the Government, the exchange's reconstituted board and by other groups, such as the working parties set up to advise on the various market divisions (metals, agriculturals, indices, currencies and interest rates).

The exchange has carried out a detailed programme aimed at eliminating any weaknesses amongst members and instituting controls to minimise the risk of problems in the future.

In the past year, every member firm which trades on the exchange's markets has been visited by a HKFE auditing team. They ensured that a client's money was not only segregated from the firm's money, but also from that of other clients.

They checked the liquidity of members to make sure they could meet their margin calls every trading day. They studied procedures, the correctness of documents for clients and proper adherence to the Ordinance and the exchange's rules.

Having completed this survey of all actively trading members — without finding any serious irregularities — the HKFE auditing teams have moved on to study the procedures of firms that do

their futures trading overseas, but are nevertheless bound by the exchange's rules.

The exchange has also enlisted the co-operation of Peat, Marwick, Mitchell to produce a booklet on accounting for futures trading firms. It lays down recommended accounting procedures for futures trades whether or not they qualify as hedges, sets out international controls to minimise risk and advises on taxation for resident individuals and firms as well as non-residents.

Another major area of activity has been the designing of a computer software system to help HKFE members keep their books and records more efficiently. With the help of the Commodities Trading Commission, it has been programmed to produce the regular flow of information futures trading brokers need and automatically to give warning signals regarding margin calls, credit control and compliance with the law and exchange rules. It also produces documentation needed for clients such as contract notes and account statements.

Most of the necessary preparations for Hang Seng Stock Index futures trading have now been carried out. A series of seminars for members was launched as early as January. These were attended by more than 100 active members and their staff, and by some potential members. The seminars focused upon the Hang Seng Index futures contract itself and its use in portfolio hedging.

The Hang Seng Bank has been a most willing and helpful ally for the exchange

throughout. Futures trading requires calculation of the index on a minute-by-minute basis rather than the current three times daily (11.30 am, 12.30 pm, 3.30 pm).

In recognition of this, the bank has installed software that will allow its computer to carry out minute-by-minute calculations to be transmitted to the HKFE

Discussions are continuing on areas of co-operation such as exchanging technical expertise and the possibility of linked trading in some financial instruments. The HKFE believes that currency options and interest rate options would fill significant gaps in the services offered by Hongkong as the third largest international financial centre.

Further plans call for the opening of a gold futures contract based on the kruggerand, expansion of the agricultural markets and launching of futures contracts in currencies and interest rates.

Timing is often crucial when launching new contracts. Although a major revision of legislation and regulations has been necessary this time, I would hope that future proposed contracts are not hampered by the same delays that have occurred in recent years.

Hongkong has traditionally ranked as the world's third gold trading centre after New York and London. This is still the case, but a strong American dollar and consequent flat markets have reduced activity considerably. Volume in the past year on the 80-year-old Chinese Gold and Silver Exchange Society is estimated to be down by more than half. Part of this is also due to the US dollar-Hongkong dollar peg which makes arbitrage less attractive.

Volume on the Loco London markets has also declined considerably although in recent years this "dealers" market has exceeded trading on the Chinese Gold and Silver Exchange by some four to five times.

Usually slow to react to



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trading floor, the stock exchanges and the offices of members and interested parties.

During the past 12 months, the HKFE chairman, Dr Kim Cham, entered into talks with the Philadelphia Board of Trade and Philadelphia Stock Exchange with a view to possible co-operative activities. The Philadelphia Stock Exchange is a leading market in the US in the trading of options on stocks, indices and currencies.

changes elsewhere, the London markets have had their share of innovations and changes.

Traded options commenced in copper, aluminium and zinc, but the single biggest impact on the market was that of currency options on the London International Financial Futures Exchange. A link-up to trade options with the Hongkong Futures Exchange has been initiated by London.

A unique introduction to the futures world occurred last month with the launching of freight futures on the Baltic International Financial Futures Exchange (Bifex).

A major setback to the City of London was the discontinuation of the London gold futures contract as well as the rubber contract.

Due to the weakness and volatility of sterling there has also been a tendency to trade contracts in US dollars. Internationally most of the action has, as usual, focused on the American markets.

Last summer saw the beginning of a period in the United States where financial futures — futures in debt instruments, currencies and stock indices — began to displace the more traditional commodities as the leader for American markets.

This metamorphosis has had an impact on the composition of the American marketplace in several ways, including increased competition for established commodity brokerage houses and some shifting in the focus of American exchange management.

As one outgrowth of this phenomenon, 10 major banks now hold seats on the Chicago Board of Trade. A darker side to this realignment is an estimated record 23 futures brokerage firms merged or closed during the year.

Consistent with such trends, several stock and stock options markets are becoming futures exchanges. In the past year the American Stock Exchange,

the Philadelphia Options Exchange and, most recently, the Chicago Board Options Exchange, have each established futures exchanges for trading commodities such as gold, stock indices, Eurodollars, and currency options, the New York Stock Exchange having done so several years earlier.

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For more traditional commodities such as metals and agricultural products, "flat" markets seem the norm thus far. However, a major disruption of the gold market occurred with the collapse of a small Comex clearing firm, Volume Investors (VI), as a handful of customers defaulted on gold options positions when the market turned sharply bullish.

As a curious next step, accounts of all other customers at VI, thought to be fully protected under US bankruptcy and fund segregation rules, were attached by the Clearing Association to partially compensate Comex clearing members.

This action, in turn, has generated some confusion and even concern among the American brokerage community and at the Futures Trading Commission.

However, the VI case falls at an interesting time for US authorities. As Washington's budget problems become intense, the Futures Trading Commission is being required to absorb its share of federal budget and personnel cuts.

In turn, this is speeding the process of passing the onus of day-to-day supervision of American futures firms to a rapidly growing National Futures Association (NFA). As a self-regulatory organisation for the futures industry, the NFA allows American exchanges to remain the first line of defence for regulating their

markets and members, with the NFA responsible for US brokerage firms and their dealings with customers.

The Futures Trading Commission remains the direct overseer of American futures exchanges and the NFA, as well as the prime source for all regulations and enforcement activities in the United States.

established international prominence will increasingly involve reference to universal regulatory concepts of sound business practice and fair dealing.

This is a challenge Hongkong should clearly be prepared to meet, although it is doubtful that exact imitation of American standards and regulatory practices is the best route to such ends.

In Hongkong, sound, well regulated markets should result from enlightened government oversight, responsible exchange self-regulation, and a clear dedication by all parties to achieving and maintaining predominance for Hongkong as the futures trading centre of Southeast Asia and the Pacific. ■

(Mr Nicholas is president of the management committee of the Hongkong Futures Exchange and executive director of Wocom Holdings Ltd.)

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