Unfit and Improper?

The Case for Reviewing the Hong Kong Government's Ownership of the London Metals Exchange

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EXECUTIVE SUMMARY

Summary

According to the UK Government's recent refresh of the Integrated Review, the London Metals Exchange is the 'world centre for the trading of industrial metals. The majority of global non-ferrous metal futures business is transacted on LME platforms.'

The recent refresh of the Integrated Review describes the London Metals Exchange as one of the UK's strategic "strengths". However, what it fails to mention is that in July 2012, as part of the "Golden-Era of Relations" between the UK and the People's Republic of China, the London Metals Exchange was bought by the Hong Kong Exchanges and Clearing (HKEX) for £1.4 billion.

The Hong Kong Government is the largest shareholder of HKEX and appoints six out of the thirteen directors on the board. The current Chairman of HKEX, Laura Cha, was a member of Hong Kong's Executive Council from 2004-2022 and currently sits as a director on the London Metals Exchange.

The over the market purchase and the small return in profits the Hong Kong Government has received from the exchange reaffirm that the rationale for its purchase and ownership have been its strategic value.

Following the decision by the London Metals Exchange to suspend nickel trading on 8 March 2022, and after Chinese metals' billionaire Xiang Guangda, who is close to the Chinese Communist Party, found himself in a disastrous position while attempting to short the price of nickel, the exchange is currently being investigated by the Bank of England and the Financial Conduct Authority.

Given the human rights crackdown in Hong Kong which is slowly expanding to target the business and regulatory environment in the city, **this paper argues that the Bank of England and the Financial Conduct Authority should expand their investigation to look at the risks and implications of the Hong Kong Government's indirect ownership of the London Metals Exchange.**

Under the National Security Law, HKEX is legally bound to 'respect and carry out decisions of the HKSAR Committee for Safeguarding National Security' and cannot interfere in any decisions made by this committee chaired by the Chief Executive which is tasked with implementing the ongoing human rights crackdown in Hong Kong.

This paper argues that HKEX, which is owned by the Hong Kong Government, does not meet the Fit and Proper Person Test to continue to own the London Metals Exchange.

Given the strategic importance of the exchange for the global metals industry, particularly to the green energy transition, the increasing risk of the weaponisation of critical metals by authoritarian states like the People's Republic of China, and the ongoing active complicity of the Hong Kong Government in violating the Sino-British Joint Declaration, we believe there is a strong case to consider whether it is appropriate for HKEX to continue to own the London Metals Exchange.

As the business and regulatory environment in Hong Kong continues to change as a result of the ongoing human rights and security crackdown, Ministers should consider the national security treatment of investment from businesses with links to the Hong Kong Government in line to mirror the treatment of business with links to the People's Republic of China.

This could include publishing an annual list of countries with non-market economies, whose companies would be restricted from owning strategic assets in the UK and in the City of London.

Ministers should consider an audit of the UK assets currently held directly or indirectly by the Hong Kong Government, which may serve as a conduit for businesses linked to the Government of the People's Republic of China.

The Houses of Parliament Intelligence and Security Committee should consider expanding its inquiry into China to look at the impact of Chinese intelligence services activities and investment has had on the City of London and the UK financial services sector.

Background

The London Metals Exchange is one of the oldest international metal exchanges in the world, established in 1877. The international exchange trades raw and increasingly strategic metals including nickel, aluminium, copper, zinc, lead, steel and tin.

In 2021, $13.2 trillion worth of assets amounting to 3.1 billion tonnes of metals were traded on the exchange.

According to the Government's recent refresh of the Integrated Review, the London Metals Exchange is the 'world centre for the trading of industrial metals. The majority of global non-ferrous metal futures business is transacted on LME platforms.'

Although the bulk of the world's metal trading takes place outside of exchanges, between direct contract relationships, the metal traded on the London Metals Exchange is often surplus used to hedge the prices buyers and sellers are receiving in physical markets and come up with a reference against which they can benchmark these trades.

Traders in particular pay close attention to the inventories of metal held in the London Metals Exchange warehouses because they are seen as evidence of how tight the wider market is.

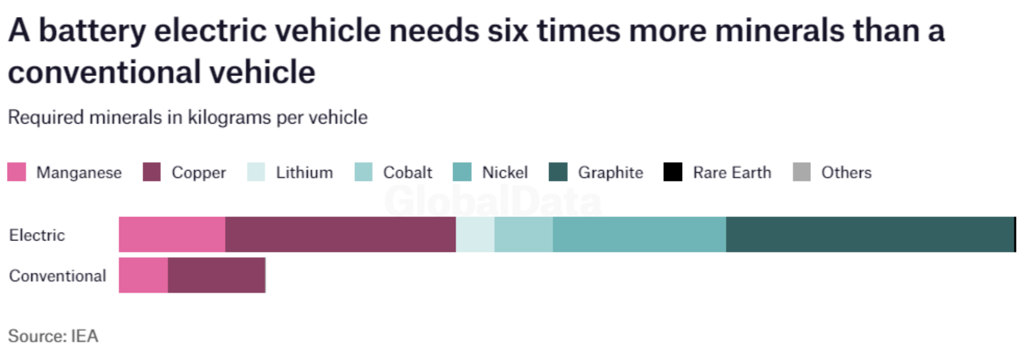
In July 2012, as part of the "Golden-Era of Relations" between the UK and the People's Republic of China, the London Metals Exchange was bought by the Hong Kong Government and the Hong Kong Exchanges and Clearing for £1.4 billion.

Strategic importance of critical minerals and metals traded on LME

The Integrated Review describes the London Metals Exchange as one of the UK's strategic "strengths". Of course, what it fails to mention is that the Hong Kong Government through the Hong Kong Exchanges and Clearing is the current owner of the London Metals Exchange.

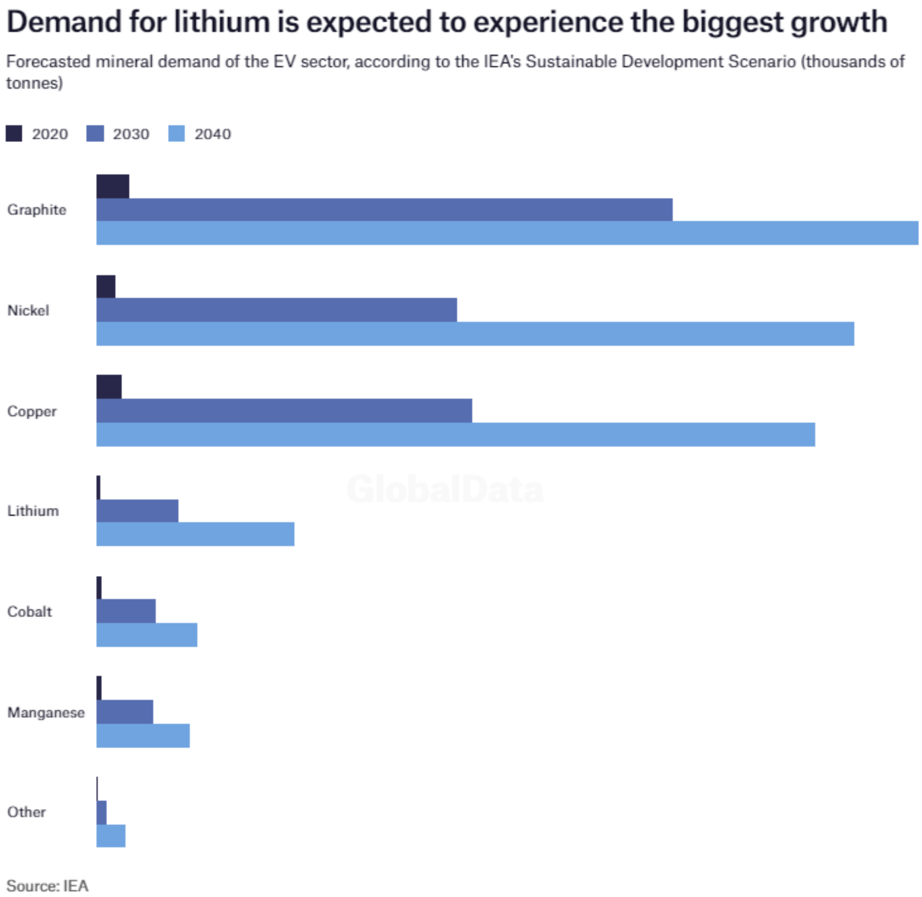
Many of the metals traded on the exchange are considered critical raw minerals. The EU in its Critical Raw Minerals Strategy lists aluminium, nickel, and copper as critical minerals. Similarly, the US Government lists aluminium, nickel, tin, and zinc as critical minerals. The UK's own critical ministers strategy states that 'it is in the UK's interests to support well-functioning markets and responsible, traceable supply chains, to help de-risk investments and development of new projects.'

The price of nickel in particular has a significant impact on the plans for the decarbonisation of the UK and other countries' economies, as the metal is a vital component in electric car batteries.



Nickel is a critical ingredient in the lithium-ion battery cells used in most electric vehicles. Even prior to Russia's war in Ukraine, analysts were warning of a likely shortage of high-grade nickel as global automakers ramp up production of electric vehicles to meet climate targets.

The global demand for nickel used in electric vehicle batteries is expected to rise from 60,000 metric tons in 2018 to some 665,000 tons worldwide by 2025. The International Energy Agency calculates that the average electric car requires six times the mineral inputs of a conventional gas-powered car.



The UK Government has committed to ensuring that all new cars and vans would be zero-emission by 2035 and plans to introduce a mandate by next year which will require a percentage of manufacturers' new car and van sales to be electric and zero emission.

Labour, the current official opposition and a potential incoming government after the next election, has pledged to build three gigafactories for electric car battery production in Britain by 2025.

However, currently the only gigafactory being built in the UK is being built by the Chinese company Envision in Sunderland.

Both of the commitments from the current Conservative Government and a potential future Labour Government will increase the UK's demand for nickel and other critical minerals to meet their zero-emission targets.

The International Energy Agency has cautioned that the growing race to secure critical minerals for the transition to zero carbon economies if managed poorly could lead to significant greenhouse gas emissions, environmental impacts including a loss of biodiversity, and social impacts including increased fraud, corruption, and human rights abuses particularly when it comes to the use of child labour.

The potential weaponisation of critical metals and minerals

Russia

CitiGroup have warned that Russia, one of the largest exporters of aluminium and palladium, could weaponise its minerals and restrict their export which would disrupt global commodity markets, supply chains, and create problems for manufacturers.

As it stands, Russia's critical mineral export market has largely been untouched by Western sanctions. US and EU imports of Russian aluminium and nickel increased by as much as 70% from March-June 2022, despite Russia's invasion of Ukraine.

The London Metals Exchange initially considered banning Russian metal exports from its market following the invasion of Ukraine, but decided against the move in November 2022.

The PRC

Given its substantial industrial base, the People's Republic of China is both a net importer and a net exporter of raw metals, including being the largest producer of aluminium and an exporter of lead, refined zinc, cooper, and nickel.

In 2020, the PRC exported $180bn in metals making it the largest metals exporter. In the same year it imported $108bn worth of metals making it the second largest metals importer.

Where the PRC dominates is the refining of critical minerals and metals. According to the International Energy Agency, China's share of refining is around 35% for nickel, 50-70% for lithium and cobalt, and nearly 90% for rare earth elements. On top of this, Chinese companies have a significant market share and presence in other countries with a high concentration of critical minerals and metals including: Australia, Chile, the Democratic Republic of Congo and Indonesia.

According to a report from the Green Finance & Development Center at Fudan University in Shanghai, Chinese investments and new contracts in the mining and metals sector topped $10bn in the first half of 2023.

On 3 July 2023, the PRC introduced export restrictions on Gallium and germanium, two metals which are critical to the construction of semi-conductor chips, in order to "safeguard national security and interests". This has largely been seen as a retaliation to semi-conductor export restrictions from the US and Netherlands.

This is a playbook the PRC has used before back in 2010 in a fishing dispute with Japan, when it introduced export controls on critical minerals to the country and cut export quotas of rare earth minerals to the rest of the world.

There is a risk that as relations deteriorate between the PRC and the West that it could consider expanding export controls on critical minerals either unilaterally or in partnership with Russia in an attempt to control the critical mineral market.

The PRC's weaponization of investment into the UK

The Intelligence and Security Committee of Parliament in its report on China noted 'that since 2017, the majority of Chinese investment in the UK appears to have been strategically driven, with clear links between areas of investment and Chinese state objectives.'

We would argue that in fact that investment pre-dating 2017 has similarly been strategically driven with key Chinese state objectives in mind, including the Hong Kong Clearing Exchange's purchase of the London Metals Exchange.

The report goes on to state that 'the Chinese Communist Party co-opts every state institution, company and citizen. This 'whole-of-state' approach means China can aggressively target the UK, yet the scale of the activity makes it more difficult to detect.'

It concludes that 'Chinese intelligence services target the UK and its interests prolifically and aggressively, with economic espionage a prominent motivation.'

In 2021, financial services contributed £173.6 billion to the UK economy, 8.3% of total economic output. The Chinese Embassy in the UK is noted for its prominent engagement with banks, the City of London Corporation, and other members of the square mile. It is therefore a notable omission that the Intelligence and Security Committee's report on China does not look at the impact Chinese investment has had on the UK financial services industry.

Financial Conduct Authority and the Bank of England's current investigation into the London Metals Exchange

The London Metals Exchange is currently the subject of two separate investigations by the Financial Conduct Authority and the Bank of England following a decision by the exchange to suspend trading of nickel on 8 March 2022.

Overview

The decision by the London Metals Exchange to suspend nickel trading came after Chinese metals' billionaire Xiang Guangda, who is close to the Chinese Communist Party, found himself in a disastrous short position that could have cost him both his personal fortune and that of the Chinese nickel producer the Tsingshan Holding Group.

Xiang Guangda is the founder of China's leading stainless steel and nickel producer Tsingshan Holding Group, which is worth $4.1 billion.

Xiang's Tsingshan Holding Group supplies large volumes of nickel to electric vehicle battery manufacturers at home, and is one of China's flagship companies delivering Belt and Road projects across abroad. With recorded company revenue of $19 billion in 2021 and a sprawling business empire, Xiang's family is one of the wealthiest and most powerful in Zhejiang.

In March 2022, Tsingshan Holding Group was set to face $8 billion in losses after the price of nickel doubled to over $100,000 per tonne. Xiang, fondly referred to as "big shot," had staked a sizable amount of his personal fortune shorting nickel, only to see the price of the metal surge by 111 percent as a result of the ongoing economic fall-out of Russia's war in Ukraine.

On 8 March 2022, the London Metals Exchange, which is owned by the Hong Kong Government, made an unprecedented decision to suspend nickel trading in a move not seen since 1985, cancelling 5,000 nickel trades that had been executed that day, and wiping out $1.3 billion of profit and loss on deals. The next day Shanghai's Futures Exchange followed suit and also froze nickel trading.

The view from the London Metals Exchange

In a court case relating to one of the law suits brought against the London Metals Exchange, the exchange said it was unaware of the size of the short position held by Xiang Guangda due to many of the positions not sitting on the exchange itself.

The court also heard that Xiang's attempts to short the price of nickel were an open secret and Bloomberg ran a piece on it on 14 February 2022, three weeks before the metals exchange suspended trading on nickel.

At the time that trading of metal started in Asia at 1am UK time on 8 March 2022, it has been reported that the London Metals Exchange had only junior staff watching nickel trading. By 4:49am, the operations team of the London Metals Exchange had suspended price bands which are a "speed bump" designed to limit extreme price moves in the metals market.

Mathew Chamberlain, Chief Executive of the London Metals Exchange, woke up at 5:30am on 8 March 2022 at which point the price of nickel was already $US60,000 per tonne.

At 7:30am, Chamberlain led a conference call with senior management of the metal exchange and several executives from its parent company Hong Kong Exchanges and Clearing where they agreed to suspend the market as soon as possible. No minutes were taken.

Fall Out

Following the resumption of nickel trading on the London Metals Exchange, the Financial Conduct Authority and the Bank of England announced separate investigations into the exchange.

The Financial Conduct Authority stated that it will *'review the LME's approach to managing the suspension and resumption of the market in nickel to determine what lessons might be learned in relation to the LME's governance and market oversight arrangements'*.

The Bank of England stated that it will look *'into the operation of LME Clear during the period to determine whether any lessons might be learned in relation to its governance and risk management'*.

In its annual Global Financial Stability report, the International Monetary Fund called for the London Metals Exchange to strengthen its governance structures to avoid conflicts of interest.

On 3 March 2023, the Financial Conduct Authority and Bank of England issued a further joint statement that the metals exchange *'has implemented changes to its control framework and committed to a wider package of market reform, informed by the recommendations of an external review LME and LME Clear jointly commissioned'*.

The Financial Conduct Authority also confirmed that it has opened an enforcement investigation into the suspension of nickel trading, which could see the metals exchange facing fines and or its staff facing bans.

The London Metals Exchange also faces law suits that currently amount to around $581 million from investors who had their nickel trades suspended by the exchange, the largest of which is the Elliot Management Corp who are seeking $456 million.

Aside from the current investigations regarding the pausing of nickel trading, the London Metals Exchange has faced criticism regarding the management of its warehouses where critical metals are deposited. In March 2023, the Financial Times reported that warehouses run by the London Metals Exchange had accepted fake consignments of nickel that turned out to be bags of stones.

Ownership of the London Metals Exchange

Purchase

Historically, the London Metals Exchange was owned by its members which were largely UK based metal merchants and run by a Chief Executive appointed by members. In 2012, the metals exchange was sold off to the Hong Kong exchange for £1.4bn.

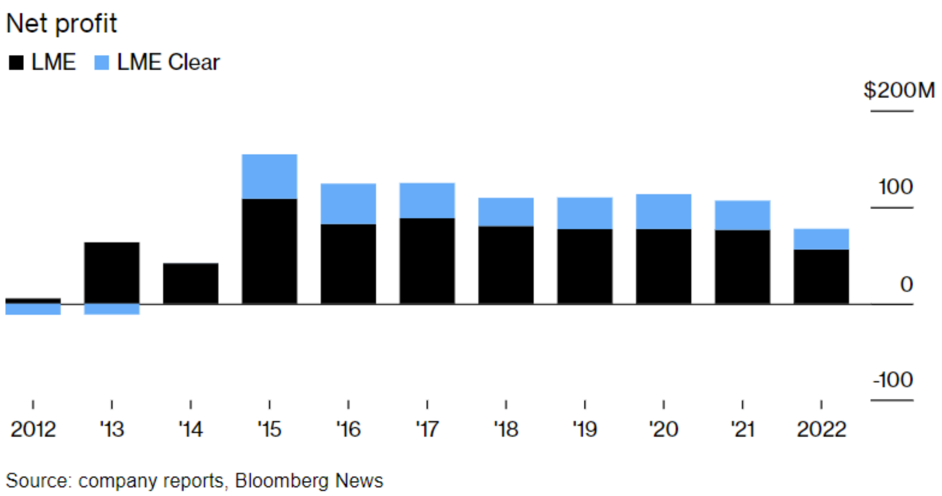
The takeover was funded by a bridge loan from UBS, China Development Bank, Deutsche Bank and HSBC, with the Hong Kong exchange refinancing with an equity issue after the deal closed.

At the time of the acquisition, the Financial Times reported that some industry experts were unnerved by the Hong Kong Exchange taking over the London Metals Exchange as the Hong Kong government appoints six of its 13 directors and is the largest shareholder.

Commenting on the purchase of the exchange, Ruben Lee, chief executive officer of Oxford Finance Group, said on 18 June 2012, “UK regulators will maintain their control over the operations of the exchange. There will be concern about the fitness and the properness of any new owner, but I’m sure that Hong Kong Exchanges & Clearing are going to satisfy that.” The deal was approved by the metal exchanges shareholders and received regulatory approval from the UK Financial Services Authority (the predecessor of the Financial Conduct Authority) whose sole concern according to the regulators handbook at the time was that Hong Kong Exchanges and Clearing does not “pose a threat to sound and prudent management” of the markets operated by the London Metals Exchange.

When the Hong Kong Exchange bought the London Metals Exchange, they paid significantly more than it was worth, with one analyst suggesting to Hong Kong Watch it was “58 times its price-to-earnings ratio at the time.”

Similarly, the annual profits of the London Metals Exchange and its clearing platform London Metals Clear raised just over $107m in 2021.



The over the market purchase and the small return in profits the Hong Kong Government has received from the exchange reaffirm that the rationale for its purchase and ownership have been its strategic value.

Structure

Directors of the London Metals Exchange are in theory independently appointed, but according to its terms of reference for directors they must *'seek to promote the success of the company for the benefit of Hong Kong exchange as the Company's ultimate parent company'*.

At least five of the directors of the London Metals Exchange also serve as directors of the Hong Kong exchange, including Laura Cha who is not only the current Chairman of the Hong Kong Exchange and a non-executive director of HSBC, but also served as a member of the Hong Kong Government's Executive Council from 2004-2022 and was a delegate to the National Congress of the Chinese Communist Party.

Laura Cha publicly welcomed China's imposition of the National Security Law on Hong Kong in July 2020, describing it as a "good thing" and saying that it would only be "targeted at a very small group of people". As of 31 March 2023, 249 individuals in Hong Kong have been arrested under the draconian security law including journalists, trade unionists, and opposition lawmakers.

The Hong Kong Exchange formally endorsed the National Security Law on 6 June 2020, with its then Chief Executive Charles Li claiming the law will have no bearing on any laws and regulations governing commercial activities, contractual arrangements, financial transactions, capital flows, dispute resolutions and the movement of people or talent and flows of information and data.

In the past, the stock exchange has faced criticism for allowing the IPO launch and listing of SenseTime which is currently blacklisted by the USA for its development and use of surveillance cameras in internment camps in Xinjiang which identify Uyghur Muslims.

Analysts have also noticed a steady uptick in the number of Russian companies that have listed in Hong Kong since Russia's invasion of Ukraine and the sanctions that have followed, with the number moving to Hong Kong doubling between February and October 2022.

Relationship between HKEX and Hong Kong Government

The Hong Kong Government is the largest shareholder of HKEX and appoints six out of the thirteen directors on its board.

As mentioned above, the current Chairman of HKEX and Exchange Laura Cha was a member of Hong Kong's Executive Council from 2004-2022. The Executive Council operates in a similar fashion to the UK Cabinet, whereby government decisions have to be collectively agreed by all members of the Executive Council, including when it comes to matters of national security.

On 30 December 2022, the Standing Committee of the National People's Congress interpreted the National Security Law to clarify that all institutions including the Hong Kong Clear and Exchange must ‘respect and carry out decisions of the HKSAR Committee for Safeguarding National Security’ and ‘no executive, legislative, judicial, or other institution, or any organization, or individual in the HKSAR may interfere with the work of the HKSAR Committee for Safeguarding National Security’.

Under the direction of the Hong Kong Government on December 23, 2022 HKEX removed the media group Next Digital that previously owned Apple Daily from the Hong Kong Stock Exchange.

Security provisions within the National Security Law cover businesses listed in Hong Kong, in particular Article 31 and Article 32 which state that businesses that breach the law can face a criminal fine or face having their licence or permit to operate revoked.

Businesses are also legally required to provide information to the Hong Kong National Security Police or any suspected violations of the National Security Law.

The National Security Law has even spread to land sales in Hong Kong, with the government including in public tenders for government land sales requirements that buyers can be disqualified if they or their parent firms engage in activities that “endanger national security” or affect public order.

On 2 August 2022, the Hong Kong Exchange removed a requirement for a China-risk section for Mainland-incorporated companies in application rules which require them to list the policy, business, and environmental risks of operating and investing in China.

This is further evidence that the Hong Kong Exchange is increasingly under the control of the Hong Kong and Chinese Government as it rolls back due-diligence and scrutiny of Chinese companies listing IPOs in Hong Kong.

The failure to purchase the London Stock Exchange

On 11 September 2019, seven years after the successful purchase of the London Metals Exchange and at the height of mass pro-democracy protests in Hong Kong, HKEX attempted to buy the London Stock Exchange for $36.6bn.

The London Stock Exchange’s ownership of the London Clearing House (which owned 82% at the time) which clears half of the world’s interest rate swap, and is the second largest clearing house for bonds and repos that serve 13 government debt markets, meant that this bid would have required the approval of regulators in the USA, Italy, Germany, France, alongside the UK.

Unlike in 2012 with the London metals exchange, this surprise bid for the London Stock Exchange was met with a cool response from regulators, UK ministers, and the stock exchange itself.

The UK Business Secretary at the time, Andrea Leadsom MP, said that the Government would "look very carefully at anything that had security implications for the UK".

On 13 September 2019, Chairman of the London Stock Exchange, Don Robert, released a letter which Bloomberg described as a "scathing rejection" of HKEX's bid for the exchange, stating that the crackdown on pro-democracy protests made HKEX's position as a strategic gateway in the longer term uncertain.

In the letter, Chairman Don Robert also argued that HKEX's "unusual structure" and its "relationship with the Hong Kong Government" would complicate any takeover.

Does the Hong Kong Government meet the fit and proper person test to own the London Metals Exchange?

The Fit and Proper Person Test

In the UK, the Fit and Proper Person Test is used widely across society to prevent corrupt or untrustworthy people from serving on the board of certain organisations from football teams to NHS trusts to businesses.

The purpose of the Fit and Proper Person Test is to sift out and block individuals from owning UK companies that have a criminal record, outstanding convictions, are potentially corrupt, or are likely to be unable to financially manage the business.

There is no standard criteria for the Fit and Proper Person Test that is applied across the board, but looking at the criteria for the Fit and Proper Person Test used by the Financial Conduct Authority for its own internal purposes, this includes whether the individual or institution has:

1. Honesty, integrity, and a good reputation.
2. Competence and capability.
3. Financial Soundness.

Given that the HKEX and Exchange is owned by the Hong Kong Government it is well worth asking whether the Hong Kong Government can meet this test?

Hong Kong Government's credentials

After all, the Hong Kong Government is run by a Chief Executive who has been sanctioned by the United States for his involvement in gross human rights violations along with a number of other Hong Kong officials.

The Hong Kong Government has jailed journalists, lawmakers, trade unionists, closed down independent media organisations and regularly denounces information written in the international press regarding the human rights situation in Hong Kong.

On 3 July 2023, the Hong Kong Government issued arrest warrants and bounties for eight pro-democracy activists living overseas in the UK, USA, and Australia, for supposed statements they made violating the city's National Security Law. The National Security Police subsequently detained the family members of these individuals for questioning.

It is also blocking over £2.2 billion worth of pension savings from over 90,000 Hong Kongers who have moved to the UK under the British National Overseas Visa scheme from leaving the city.

You would be hard pressed to find someone who would honestly conclude that Hong Kong Chief Executive and former Security Minister, John Lee, is a fit and proper person and qualified to indirectly own a strategic asset such as the London Metals Exchange.

The National Security and Investment Act

On 4 January 2022, the UK Government introduced a new national security screening mechanism through the National Security and Investment Act. Under the act, Ministers are given the power to intervene in investments and other acquisitions of entities and assets where they could harm the UK's national security.

The Act specifies 17 sensitive sectors of the UK economy where Ministers have the power to intervene over acquisitions. These sectors include: Defence, Military and Dual Use, Critical Suppliers to Government, Artificial Intelligence, Data Infrastructure, Advanced Materials, Energy, Critical Suppliers to The Emergency Services Sectors, Computing Hardware, Cryptographic Authentication, Communications, Satellite and Space Technology, Quantum Technologies, Transport, Civil Nuclear, Advanced Robotics and Synthetic Biology.

In 2022, the UK Government revealed that it intervened and stopped eight transactions involving Chinese-linked investment in British companies. Of the acquisitions that were initially called in by Ministers around 42% of call-ins involved acquirers associated with China.

During the "Golden-Era" of relations between the UK and the PRC, China invested in over £80 billion of UK assets. Two-thirds of these acquisitions were finance and low-tech sectors such as property and logistics.

Sadly, the National Security and Investment Act has no mechanism for reviewing past acquisitions by the PRC or its proxy the Hong Kong Government in the UK. Even if these investments pose considerable concerns regarding the UK's national and economic security.

Recommendation: Reviewing the ownership of the London Metals Exchange

Central recommendation

We recommend that the FCA and the Bank of England expand their ongoing investigation into the London Metals Exchange to look at the question of its current ownership.
Given the strategic importance of the exchange for the global metals industry, the ongoing human rights crackdown in Hong Kong, the suspension of nickel trading in support of a Chinese billionaire aligned with Xi Jinping, and the PRC's restrictions on metal exports, we believe there is a strong case to consider whether it is appropriate for HKEX to continue to own the London Metals Exchange.

We urge the FCA and Bank of England to expand their ongoing investigation to cover whether the current owners of the London Metals Exchange meet the fit and proper test.

The conclusion of this investigation should be shared with the Government, and Ministers should take action to review the ownership of the London Metals Exchange and whether there is a mechanism to force the Hong Kong Government to sell this strategic UK asset.

Further recommendations

As the business and regulatory environment in Hong Kong continues to change as a result of the ongoing human rights and security crackdown, Ministers should consider changing the National Security treatment of investment from businesses with links to the Hong Kong Government to mirror the treatment of businesses with links to the People's Republic of China.

This could include publishing an annual list of countries with non-market economies, whose companies are restricted from owning strategic assets in the UK and in the City of London.

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