



Hong Kong

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SFC CONSULTS ON CHANGES TO THE GUIDELINES FOR REGULATION OF AUTOMATED TRADING SERVICES

Introduction

The Securities and Futures Commission (**SFC**) published its Consultation Paper on Proposed Amendments to the Guidelines for the Regulation of Automated Trading Services (the **ATS Guidelines**) on 20 November 2015.¹ A draft of the revised ATS Guidelines is included in the appendix to the consultation paper.

Background: Hong Kong regulation of automated trading services

Providing automated trading services in Hong Kong has been regulated under the Securities and Futures Ordinance (**SFO**) since 2003. There are two regimes for regulating ATS providers:

a) *Part V ATS licence/regulation*

A person may seek a licence/registration to provide ATS under Part V of the Securities and Futures Ordinance. The Part V ATS regime is suitable for situations where provision of the ATS is incidental to the performance of a dealing function. A typical Part V ATS Provider is an intermediary which provides dealing services, and ATS is an additional facility offered to its clients.

b) *Part III ATS authorisation*

A person seeking to provide ATS can do so under Part III of the Securities and Futures Ordinance. Under the Part III regime, provision of ATS should be the core function of the applicant. A typical Part III ATS Provider offers facilities that are similar to those of a traditional exchange or clearing house.

The ATS Guidelines set out the principles, procedures and standards which govern the provision of ATS in Hong Kong. They provide further explanation of the differences between Part III ATS authorisation and Part V ATS licence/registration and the situations in which each is appropriate.

Why are amendments required?

The number of entities seeking a Part III ATS authorisation has been increasing. They are largely operators of overseas regulated exchanges and trading facilities, including financial futures exchanges, stock exchanges, commodity futures exchanges and equity or fixed income trading facilities. It is expected that the number of applications will further increase as the market continues to develop.

The proposed amendments to the ATS Guidelines are intended to address regulatory and other developments, as well as the SFC's experience of regulating ATS. The following four reasons are highlighted as driving forces behind the proposed amendments:

¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=15CP5>

a) *Regulation of the Hong Kong OTC derivatives market*

There have been global efforts to reform the OTC derivatives market. In March 2014, the Securities and Futures (Amendment) Ordinance 2014 (**Amendment Ordinance**) was enacted to provide a framework for regulating the OTC derivatives market in Hong Kong. The Amendment Ordinance introduced several changes, including:

- An expanded definition of ATS to include not only services for the trading or clearing of securities or futures contracts, but also services for the trading or clearing of OTC derivatives.

In 2016, the clearing leg of the expanded ATS definition is expected to come into effect. As a result, central counterparties (**CCPs**) (including those based overseas) who currently provide, or market, clearing services for OTC derivative transactions to persons in Hong Kong will need to be authorised as Part III ATS providers. The proposed amendments cater for the expanded definition and provide guidance for those seeking authorisation.

- A mandatory clearing obligation is also introduced under the regime for OTC derivatives. This will require certain standardised OTC derivative transactions to be cleared through a designated CCP – which is either a recognised clearing house (**RCH**) or a Part III ATS provider.

The first phase of mandatory clearing is expected to be introduced in mid-2016.² Overseas CCPs may seek to become authorised ATS providers so that they may serve as designated CCPs for the purposes of the mandatory clearing obligation. Consequently, amendments are required to provide guidance on the regulation of ATS providers that also serve as designated CCPs.

b) *Improved alignment with international standards and practice*

² See the Consultation paper on introducing mandatory clearing and expanding mandatory reporting issued jointly by the SFC and the HKMA in September 2015: <http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2015/20150930e7a1.pdf>

Since the publication of the ATS Guidelines, there have been major changes in the international regulatory standards and best practices. The publication of the Principles for Financial Market Infrastructures (**PFMI**) is one example. The SFC proposes to expand and enhance the core standards of practice currently embodied in the ATS Guidelines in line with the relevant PFMI requirements.

c) *Codification of practices*

In the past decade, the design, operation and use of ATS have evolved. In that period, the SFC's understanding and experience of regulating ATS have also been enhanced. The ATS Guidelines will therefore be updated to take these developments into account and to codify the SFC's practices.

d) *Housekeeping changes*

For the purpose of streamlining the ATS Guidelines, the SFC also proposes housekeeping changes to keep the guidelines up-to-date.

Key Changes Proposed

A) **Implementation of the mandatory clearing and trading obligations for OTC derivative transactions in Hong Kong**

A global reform of the OTC derivatives market began as a result of the 2008 global financial crisis. Advocated by the G20 leaders, the reform recommended that standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through CCPs.

Hong Kong is one of the many jurisdictions working to implement the G20 recommendations.

The Amendment Ordinance enacted in March 2014 introduced several changes to the SFO:

- a) The definition of automated trading services under the SFO was expanded to include services for the trading or clearing of OTC derivatives. This expands the scope of ATS that may be authorised under Part III of the SFO and those that may be licensed/registered under Part V of the SFO.

- b) The licensing regime under the SFO was expanded to cover activities in the OTC derivatives market. In particular:

- i) The expanded definition of ATS means that the scope of Type 7 regulated activity (providing ATS) is expanded;
 - ii) Type 9 regulated activity (asset management) is expanded to include the management of portfolios that include OTC derivatives; and
 - iii) Two new regulated activities are introduced: Type 11 regulated activity (dealing in and advising on OTC derivative products) and Type 12 regulated activity (providing client clearing services for OTC derivative transactions).
- c) Under the Amendment Ordinance, there are also plans to introduce a mandatory clearing obligation and a mandatory trading obligation. Under the former, certain OTC derivative transactions will have to be centrally cleared through designated CCPs that are either a RCH or a Part III ATS provider. Under the latter, certain OTC derivative transactions may only be traded on designated trading platforms that are either a recognised exchange company or a Part III ATS provider.

The OTC derivatives regime is intended to be implemented in phases. Mandatory clearing will be implemented first and will apply only to a limited scope of persons and products. Mandatory trading, and the expanded licensing regime, are set to be introduced later.

The introduction of the mandatory clearing phase (targeted to begin mid-2016) and the expanded clearing leg of the expanded ATS definition will require market participants who currently provide ATS for clearing OTC derivative transactions to be authorised under Part III of the SFO.

Specific guidance on the application requirements and procedures for CCPs offering clearing services for OTC derivative transactions, including those that also seek CCP designation for the purposes of the mandatory clearing obligation, is set out at paragraphs 55(b) and 62 to 64 of the draft revised Guidelines.

B) Improved alignment with international standards and practice

The SFC pays due regard to international standards and best practices when regulating ATS, including regulatory principles, standards and practices recommended by IOSCO and the Committee on Payments and Market Infrastructures (CPMI).

In April 2012, CPSS-IOSCO published new standards for financial market infrastructures, i.e. PFMI. The PFMI provides regulatory standards for financial market infrastructures (FMI), which include CCPs. As a result, the SFC requires persons seeking to become an RCH or authorised ATS provider to demonstrate compliance with the PFMI. The SFC proposes to amend the ATS Guidelines so that it is clear that overseas CCPs are also expected to comply with PFMI.³

Further, the SFC proposes that the existing seven standards of practice be expanded and reorganised into nine core standards of practice, as below:

- a) “Financial resources” and “risk management” are to be separate core standards, so as to reflect the importance of each. Core standard 1 on financial resources will then focus on requiring an ATS provider to have sufficient financial resources for the proper performance of its operations, functions and obligations. Core standard 2 on risk management will focus on requiring an ATS provider to ensure that risks associated with its business and operations are managed prudently.⁴
- b) Core standard 3 on “operational integrity” will be renamed “system integrity” to better reflect the features of ATS.⁵
- c) Core standard 4 will be a new standard on “governance”, which incorporates the earlier standard on “fitness”.⁶ The revised standard will focus on management and the decision-making processes, rather than merely on the suitability or qualifications of any particular personnel or shareholder.
- d) Core standard 5 is also a new standard on “access and participation”.⁷ The new standard reflects the importance of having open and fair access to ATS, and having clear and objective criteria for such access. The SFC considers this standard to be critical given the upcoming implementation of mandatory clearing – ATS providers serving as designated CCPs will have to have objective, risk-based and transparent criteria for participation, and requirements which permit fair and open access.

³ Please see paragraph 16(c) of the draft revised Guidelines

⁴ Please see paragraphs 14 and 18 to 23 of the draft revised Guidelines

⁵ Please see paragraphs 14 and 24 to 25 of the draft revised Guidelines

⁶ Please see paragraphs 14 and 26 to 27 of the draft revised Guidelines

⁷ Please see paragraphs 14 and 28 of the draft revised Guidelines

C) Codification of practices

a) *Operations similar to an exchange or CCP*

To avoid confusion of the ATS regime under Part III of the SFO with the separate regulatory regime for persons operating stock markets, future markets and clearing houses (i.e. the regime for recognised exchange companies (**RECs**) and RCHs under the SFO), the ATS Guidelines provide guidance on the SFC's expectations where the provision of ATS may also constitute the operation of a "stock market", a "futures market" or a "clearing house" as defined in Schedule 1 to the SFO.

The SFC proposes to further expand the guidance to clarify that:

- a) Persons proposing to provide services or facilities for trading securities should take into account the restrictions on who may operate a stock market under section 19 of the SFO. They may be required to provide a legal analysis as to why their proposed operations do not contravene such restrictions.⁸
- b) Any persons proposing to provide services or facilities for trading futures contracts may apply to become an REC or an authorised ATS provider, but should take into account the differences between the two regimes when deciding which to pursue.⁹
- c) Any persons proposing to provide services or clearing facilities similar to those of a CCP should note that the SFO's insolvency override protections generally apply only to RCHs. Thus any person which is not already regulated as a CCP in its home country and enjoys adequate insolvency override protections under the laws of that jurisdiction, should apply to become an RCH rather than a Part III ATS provider.¹⁰

The SFC also proposes to include a new section to clarify the key differences between the regulatory requirements applicable to an REC and those applicable to an authorised ATS provider. The new section identifies five major regulatory differences between an REC and an authorised ATS provider. These differences are fairly significant and fundamental to the set-up of an operation, thus their inclusion in the ATS

⁸ Please see paragraph 44 of the draft revised Guidelines

⁹ Please see paragraph 45 of the draft revised Guidelines

¹⁰ Please see paragraph 46 of the draft revised Guidelines

guidelines should help prospective applicants better assess which of the two regimes is more suitable for their intended business models.

b) *Pragmatic approach*

The SFC generally takes a pragmatic approach in regulating ATS providers so that the level of regulation is commensurate with the functions performed and the risks posed. A level playing field will be sought so that similar regulation is applied in respect of similar functions.

The SFC will continue to make reference to international standards and best practices.¹¹ The draft revised Guidelines also note that the level of regulation of a domestic ATS provider may, in appropriate cases, be akin to that of an REC.¹²

c) *Impact of the regulation of offers of investment under Part IV of the SFO*

Part IV of the SFO requires certain offers of investments, including offers of structured products and interests in collective investment schemes (**CIS**), to be authorised by the SFC. While a Part III ATS authorisation would allow an ATS provider to offer and market its trading or clearing services to persons in Hong Kong, any products traded in the markets operated by an ATS provider will still be subject to the requirements of Part IV of the SFO. While certain exemptions apply in respect of listed products, these apply only to products listed on an REC and do not cover products listed on overseas markets.

It is important that an ATS provider complies with Part IV of the SFO. In the draft revised Guidelines, the SFO includes a new section highlighting the need to ensure such compliance¹³. In particular, the ATS provider is expected to take measures necessary or appropriate to ensure that neither it, nor its members, contravene Part IV of the SFO.

D) Housekeeping amendments

Removal of sections on application procedures for Part V ATS

Under Part V of the SFO, ATS constitutes a regulated activity (Type 7). Accordingly, the provisions applicable to intermediaries generally apply. The current ATS Guidelines contain a section detailing procedures for licensing ATS providers under Part V of the SFO. The SFC proposes to remove this section since

¹¹ Please see paragraph 16 of the draft revised Guidelines

¹² Please see paragraph 47 of the draft revised Guidelines

¹³ Please see paragraphs 49 – 51 of the draft revised Guidelines

comprehensive regulations and procedures already exist for the respective licensing or registration requirements of Part V ATS. Detailed information on the licensing procedures for Part V ATS is set out in the SFC's Licensing Information Booklet, which is accessible via the SFC's website.

Proposed Timeline

The SFC aims to finalise the ATS Guidelines by the first quarter of 2016. Implementation of the revised guidelines is set to commence concurrently with the subsidiary legislation for mandatory clearing, currently expected to be mid-2016.

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