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# Comments on the SFC Consultation Paper Concerning the Regulation of Alternative Liquidity Pools

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## Introduction

CompliancePlus Consulting Limited welcomes the Securities and Futures Commission (the “Commission”)’s Consultation Paper Concerning the Regulation of Alternative Liquidity Pools (the “Paper”) issued in February 2014 and takes this opportunity to comment on the proposals of the Commission in relation to the issues set forth in the Paper.

Dark liquidity and the expanded providers of Alternative Liquidity Pools (“ALPs”) have long existed in various forms such as ‘Upstairs Trading’ or internalized order crossing. However it is the recent improvement in technological ability that has resulted in a rapid growth of ALPs in Hong Kong. It is therefore a sensible phase to consult the public on their expert opinions of ALPs and the services they provide to the public of Hong Kong. Please see our reply to the proposals of the Paper.

### Question 1

**Do you agree that the proposed requirements are sufficient to ensure that an ALP operator effectively manages and adequately supervises the design, development, deployment, and operation of the ALP it operates? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.3 / Paragraph 3 to 6 of Schedule 8 as they are in line with similar management and supervision requirements.

### Question 2

**Do you agree that only the orders of institutional investors should be permitted to be transacted in ALPs? If not, why not?**

We disagree with the Commission’s concerns restricting only the orders of institutional investors to be permitted to be transacted in ALPs. We adopt this position as we believe the Commission’s concerns:

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are speculative; have not stated the reasons to bar the orders of professional investors who do not fall under the definition of institutional investors (herein referred to as “**individual professional investors**”) from being transacted in ALPs and would reduce the fairness and efficiency of the securities and futures industry of Hong Kong.

It is important to note the above two arguments were made with regards to retail investors. We find no elaboration as to the Commission’s decision to allow institutional investors, who are professional investors, to allow their orders being transacted by ALPs but not individual professional investors. As concerns over order size and complexities have been addressed in light of retail investors above, we believe the same counterarguments would support the orders of individual professional investors to be transacted in ALPs.

We further argue the use of ALPs would promote an efficient securities and futures industry in-line with the regulatory objectives of the Commission. Hong Kong is unique in that it possesses one exchange, The Hong Kong Stock Exchange (“HKEX”). Minimum spreads of the HKEX are on average 27 basis points as noted by ITG and inefficient when compared to other South East Asian exchanges such as those located in Japan (21 basis points) or Korea (21 Basis points). As the Secretary for Financial Services and the Treasury, Professor K C Chan stated to the Legislative Council, ALPs ability of “*bringing down trading costs, improving efficiency of trade execution and providing significant innovation in terms of trading services*” to reduce this spread, increase liquidity and subsequently speed up the execution would lead to an efficient market.

### Question 3

**Do you think the definition of “institutional investor” set out in the draft paragraph 19.2 of the Code of Conduct is appropriate? If not, why not?**

We disagree with the Commission’s intention to exclude individual professional investors from the definition of institutional investors.

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### **Question 4**

**Do you agree that ALP operators should be obliged to ensure that all orders placed with them by their group companies originate from institutional investors before they may be transacted in their ALPs? If not, why not?**

Whilst we disagree with the Commission's intention to exclude individual professional investors from placing orders in ALPs, we agree that client identification should be a requirement in any case to combat money-laundering and terrorist financing risks.

### **Question 5**

**Do you agree that a licensed or registered person who routes orders to an ALP on behalf of its clients should be obliged to ensure that such orders originate from institutional investors only? If not, why not?**

We agree that a licensed or registered person who routes orders to an ALP on behalf of its clients should be obliged to ensure the identity of the client in order to combat money-laundering and terrorist financing risks.

### **Question 6**

**Do you agree that ALP operators should be allowed to conduct transactions in their ALPs in all types of exchange listed or traded securities, irrespective of whether they are listed or traded in Hong Kong or elsewhere? If not, why not?**

We agree with the Commission that ALP operators should be allowed to conduct transactions in their ALPs in all types of exchange listed or traded securities, irrespective of whether they are listed or traded in Hong Kong or elsewhere. However, we note "*the SFC has been influenced by the fact that it proposes to restrict access to Hong Kong ALPs to institutional investors who, the SFC believes, should have the knowledge and sophistication required to conduct this broader range of transactions.*"

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We believe that, where ALPs operators are allowed to conduct transactions for institutional investors and individual professional investors in their ALPs in all types of exchange listed or traded securities, irrespective of whether they are listed or traded in Hong Kong or elsewhere they should assess whether their clients have the knowledge and sophistication required to conduct the broader range of transactions and in any case obtain consent from the investor as to whether such transactions may be made available to them.

### **Question 7**

**Do you agree that ALP operators should be allowed to conduct transactions in their ALPs in securities listed or traded on overseas markets / exchanges without restriction as to the time when they may do so? If not, why not?**

We agree with the Commission that ALP operators should be allowed to conduct transactions in their ALPs in securities listed or traded on overseas markets / exchanges without restriction as to the time when they may do so. We adopt this position to recognize and endorse the practice already occurring in other major jurisdictions such as the United States, European Union, Australia, Canada and Singapore as noted by the Commission.

### **Question 8**

**In respect of transactions conducted in ALPs involving securities which are listed on SEHK, do you agree that ALP operators should be allowed to conduct these transactions in their ALPs during the periods that trading is conducted on SEHK and also at other times when trading is not being conducted on SEHK? If not, why not?**

We agree with the Commission that ALP operators should be allowed to conduct transactions involving securities which are listed on SEHK during the periods that trading is conducted on SEHK and also at other times when trading is not being conducted on SEHK as the practice already occurring in other major jurisdictions.

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### **Question 9**

**Do you agree that orders received from the users of ALPs should have priority over proprietary orders of the types referred to in paragraph 34? If not, why not?**

We broadly agree with the Commission's intention to preserve honesty, fairness and diligence by requiring the users of ALPs to have priority over proprietary orders of the types referred to in paragraph 34.

### **Question 10**

**Do you agree that ALP operators should be obliged to provide prospective users of their ALPs with ALP Guidelines that are comprehensive and accurate and that their ALP Guidelines must include the matters referred to in paragraph 38? If not, why not?**

We broadly agree with the Commission that ALP operators should be obliged to provide prospective users of their ALPs with ALP Guidelines that are comprehensive and accurate and that their ALP Guidelines must include the matters referred to in paragraph 38.

However, we further advise the inclusion of contingency plans for system delay or failure be included as part of the matters referred to in paragraph 38 and the contact details of the ALPs operator for informational purposes.

### **Question 11**

**Do you agree that ALP operators should bring their ALP Guidelines to the attention of all prospective users of their ALPs? If not, why not?**

We agree with the Commission that ALP operators should bring their ALP Guidelines to the attention of all prospective users of their ALPs.

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### **Question 12**

**Do you agree that an ALP operator should be obliged to obtain formal acknowledgement from prospective users of its ALP that its ALP Guidelines have been brought to their attention and that they consent to their orders being transacted in the ALP, before such transactions are permitted to occur? If not, why not?**

We broadly agree with the Commission that an ALP operator should be obliged to obtain formal acknowledgement from prospective users of its ALP that its ALP Guidelines have been brought to their attention and that they consent to their orders being transacted in the ALP, before such transactions are permitted to occur. We would further advise that the formal acknowledgement confirms the prospective user has read and understood the guidelines.

However, we seek clarification as to whether the Commission would require formal acknowledgements after material modifications to the ALPs which would introduce practical complexities.

### **Question 13**

**Do you agree that a licensed or registered person which, on behalf of its clients, routes agency orders to an ALP operated by a third party ALP operator should be obliged to ensure that its clients have formally acknowledged that the ALP Guidelines have been brought to their attention and that they consent to their orders being transacted in the ALP, before their orders are routed to the ALP? If not, why not?**

We disagree with the Commission as licensed or registered persons are already bound to the general principles of the Code of Conduct in ensuring fair, best execution of any such agency orders.

### **Question 14**

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**Do you agree that an ALP operator should adopt measures to ensure the integrity and/or system adequacy of its ALP and have appropriate contingency measures in place? If so, are the proposed requirements sufficient? If not, why not?**

We broadly agree with the Commission that an ALP operator should adopt measures to ensure the integrity and/or system adequacy of its ALP and have appropriate contingency measures in place.

However, we would further advise for investor protection that ALP operators be required to communicate such contingency plans to investors and to inform investors of planned downtimes if any of the ALPs.

### **Question 15**

**Do you agree that an ALP operator should keep the SFC informed as to the identity of its staff having access to trading and other information relevant to its ALP, the basis upon which such access is permitted, and any change made in relation to the staff to whom such access is permitted and the basis for such change? If not, why not?**

We broadly agree with the Commission that an ALP operator should keep the SFC informed as to the identity of its staff having access to trading and other information relevant to its ALP, the basis upon which such access is permitted, and any change made in relation to the staff to whom such access is permitted and the basis for such change.

However, implementation of such a requirement may become an administrative burden for the ALP operator and the Commission, tying down resources and manpower as the popularity of ALPs and other automated trading services which may in future fall under the definition of an ALP grows. We therefore advise careful use of the term “*at all times*” as stipulated in the Code of Conduct Paragraph 17 of Schedule 8 with perhaps “*periodic*” being more suitable and flexible to the Commission.

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### **Question 16**

**Do you agree that the person responsible for originating a proprietary order in an ALP should be restricted from access to trading information or data concerning orders placed, or transactions conducted, in the ALP? If not, why not?**

We agree with the Commission that a person responsible for originating a proprietary order in an ALP should be restricted from access to trading information or data concerning orders placed, or transactions conducted, in the ALP.

### **Question 17**

**Do you agree that an ALP operator should keep proper records concerning the design, development, deployment and operation of its ALP? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.9 / Paragraph 21 to 23 of Schedule 8 as they are in line with similar record keeping requirements.

### **Question 18**

**Do you agree that an ALP operator should keep proper records concerning all transactions conducted on its ALP, including details of authorized traders? If not, why not?**

We broadly agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.9 / Paragraph 21 to 23 of Schedule 8 as they are in line with similar record keeping requirements.

However, we suggest the identity of the client entity (i.e. the entity with whom the ALPs have a contractual relationship with) be kept as opposed to the details of the individual authorized traders at the client entity, including the name, address and contact details, as the client entity details are sufficient.

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### **Question 19**

**Are the records that the SFC proposes be kept by ALP operators in relation to the transactions conducted in their ALPs sufficient and appropriate? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.9 / Paragraph 21 to 23 of Schedule 8 as they are in line with similar record keeping requirements.

### **Question 20**

**Do you agree with the proposed periods for the keeping of these records? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.9 / Paragraph 21 to 23 of Schedule 8 as they are in line with similar record keeping requirements.

### **Question 21**

**Do you agree that the proposed requirements for risk management and post-trade reviews of transactions conducted in ALPs are sufficient to maintain the fair and orderly operation of the market? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.10 / Paragraph 24 to 27 of Schedule 8 as they are in line with similar risk management and post-trade review requirements.

### **Question 22**

**Are the proposed reporting and notification requirements appropriate? If not, why not?**

We agree with the requirements set forth in the draft Code of Conduct – Paragraph 19.11 / Paragraph 28 and 29 of Schedule 8 as they are in line with similar reporting and notification requirements.

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## **Conclusion**

We welcome and broadly agree with the proposals set forth in the Paper. However, we are of the view that: the exclusion of individual professional investors, who are termed as such due to their level of sophistication, from institutional investors is not justified; and restrictions on access to ALPs is not in line with other major jurisdictions.

**END**