

# **Submission to the SFC Consultation Paper on the Proposed Amendments to the Guidelines for the Regulation of Automated Trading Services**

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**For enquiries on this submission, please contact Josephine Chung at [jchung@complianceplus.hk](mailto:jchung@complianceplus.hk). CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published by the SFC.**

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## Introduction

The enactment of the Securities and Futures (Amendment) Ordinance 2015 provided a framework for regulating the OTC derivatives market in Hong Kong. This prompted the fact that the existing Guidelines for the Regulation of Automated Trading Services (the “ATS Guidelines”) was implemented a decade ago. It naturally follows that a comprehensive review and reform is indeed appropriate and necessary at this stage.

We welcome this opportunity to provide our view on the proposed amendments to the ATS Guidelines issued by the Securities and Futures Commission (“SFC”). This submission is prepared in response to the SFC’s Consultation Paper dated November 2015 and our comments are set out below. Terms defined or given a particular construction in the Consultation Paper have the same meaning in this Response unless a contrary indication appears.

We provide our view on the Guideline as follows:-

We support SFC’s initiative in exploring the possibility of amending the ATS Guidelines, given that the Guidelines have not been amended since 2003 and a review is indeed necessary. In addition to the underlying objectives SFC would like to achieve by the proposed ATS Guideline amendments, as illustrated in paragraph 4(a) to 4(d), we are of the view that some recent event has to be taken account by the SFC in the present consultation.

In 2013, the SFC announced that it had withdrawn the authorization to provide automated trading services granted to Hong Kong Mercantile Exchange Limited (“HKMEx”), since HKMEx had failed to maintain its sufficient financial resources for the proper performance of its functions and obligations. Upon SFC’s investigation into suspected irregularities in HKMEx financial affairs, certain matters were referred to commercial crime bureau. In the end, Mr. Cheung Chun Yuen Barry (“Mr. Cheung”), the chairman of HKMEx, was convicted of the offences as illustrated in the cases ESS 14346/2014 and ESS 14347/2014. HKMEx was wound up later and Mr. Cheung himself also fell into bankruptcy. Soon after Mr. Cheung and his companies faced civil claims over loans, bills and rent amounting to millions.

## A. New Core Standard – “Competence” to be Added

The SFC proposes that the existing 7 core standards of practice for ATS provider be expanded and reorganized into 9 core standards of practice. Two new core standards, namely “governance” and “access and participation”, were proposed. The standard on “operational integrity” was amended to “system integrity” while “financial resources” and “risk management” were separated into two self-standing standards.

The SFC admitted that these core standards overlap to some extent with provisions in the SFO dealing with the regulation of intermediaries, for example provisions relating to the record-keeping obligations of intermediaries).

In particular, the proposed new core standard “governance” in the draft revised Guidelines was deemed to incorporate the earlier standard of “fitness”. The standard on fitness was included in the original Guidelines. It writes that “an ATS provider should be a fit and proper person, as established by an authority in Hong Kong or in its home country.” It also states that the SFC will have regard to the Guidance Note on Competence.

The SFC explained that the revised standard focuses on the management and decision-making processes instead of merely on the suitability or qualifications of any particular personnel or shareholder. However we are of the view that the two ideas shall be given equal importance.

In this regard we think that the standard of “fitness” shall alone deserve to be a separate standard. This new standard may be named “competence” and could include elements from the SFC’s Guidance Note on Competence. We suggest the new standard contains key concepts such as professional standards and appropriate technical training.

The SFC admitted that these amended core standards overlap to some extent with provisions in the SFO dealing with the regulation of intermediaries (e.g. provisions relating to the record-keeping obligations of intermediaries). Therefore, in the alternative, we also propose that a universal set of core standards to be applied across intermediaries and licensed corporations like ATS providers.

### **B. Universal Standard in Granting of Authorization**

Given the bankruptcy incident of HKMEx in 2013, we recommend the SFC to look back and review its due diligence process when granting authorization to a company. According to records on the SFC's website, the ATS authorization for HKMEx was granted on 26 April 2011. Back at that time, Mr. Cheung was the chairman of Urban renewal Authority since 2007 and since July 2012, he was an unofficial member of the Executive Council of Hong Kong. During that period, he worked in multiple public functions as well.

From our experience in handling SFC license applications, the SFC would refuse an application if the proposed responsible person holds too much external directorship that pose the risk of a potential conflict of interest and that the proposed responsible person may not spend sufficient time in the business of the applicant company. We are of the view that the same standard should apply to the ATS authorization as well.

At present, an applicant seeking ATS authorization is required to disclose particulars such as name, addresses, contact details and financial statements. The Guidelines also requires directors, other persons involved in the management of the applicant, and key employees that will be involved in the provision of ATS to disclose their biographies, qualifications and experience.

We propose that the regime imposes a fair and universal standard that demands disclosure of other particulars including but not limited to records of any past disciplinary actions.

We also propose that applicants shall upon application be required to demonstrate how issues relating to conflicts of interest and in particular time management are to be dealt with. This is in light of the withdrawal of authorization of HKMEx and that its chairman, Mr. Cheung, who was obviously in a position of potential conflict of interest and would not be able to spend sufficient time in the management of HKMEx.

In light of the lesson learnt from the HKMEx incident, we are of the view that the SFC should conduct due diligence on the applicant using the same standard applicable to regular license application and to give rationale to the public if a grant of authorization deviates from current licensing standard on the face of such authorization.

### C. More Transparency in Financial Resources Requirements

As a general principle, an authorized ATS provider must have financial resources sufficient for the proper performance of its functions and obligations. Whether the ATS provider is complying with such requirement should be subject to the SFC's monitoring. However, the SFC has yet to properly address the question of what suffices to "sufficient financial resources", a term which does not have a defined quantitative meaning.

The financial requirements imposed on authorized ATS providers by the SFC can be found in a Notice of Authorization to Provide Automated Trading Services where the SFC sets out conditions that attach to authorizations in pursuant to section 97 of the SFO. The conditions does not answer the abovementioned question nevertheless because the SFC decides on the conditions on a case-by-case basis.

Taking HKMEx as an example, the exact wording of the condition regarding financials in its Notice of Authorization to Provide Automated Trading Services writes "HKMEx must have financial resources sufficient for the proper performance of its functions and obligations as an authorised ATS provider."

In some other cases such as that of Singapore Exchange Derivatives Trading Limited (SGX-ST), it is provided that the ATS provider must provide its annual audited financial statements to the SFC within four months after the end of each financial year or within such other period as the SFC may agree in writing.

Learning from the past, the lesson from the HKMEx case surely remind us of the importance for the SFC to have knowledge and monitoring over the financial status of an ATS provider. This cannot be clearer as HKMEx's authorization was revoked exactly based on the ground of insufficient financial resources by falling into arrears.

As stemmed from our argument of universal standard among SFC licensed intermediaries, we are of the view that ATS providers should be required to file financial reports regularly to facilitate higher transparency as to the disclosure of information about their financial status and this should applies to all ATS providers.

As such, we suggest that the financial reporting requirements under the Securities and Futures (Financial Reporting) Rules (“FRR”) shall apply. In other words, a Part III ATS provider shall be subject to the same requirements as applicable to a Type 7 licensed corporation and this includes conformity with the minimum liquid capital amount, the trigger of notification upon liquid capital dropping significantly as well as the standard and frequency of filing.

### **D. Inclusion of ATS Activity in the Investor Compensation Scheme**

We propose that the SFC should consider including ATS in the Investor Compensation Fund scheme to increase protection of investors. This is in line with the principle for the regulation of ATS providers to secure an appropriate degree of protection for members of the public investing in or holding financial products.

The Investor Compensation Fund, established by the SFO in 2003, is a measure of compensation to clients of a specified person who sustain a loss by reason of a default committed by the specified person or any of his associated persons in connection with specified securities or futures contracts. The compensation is applied on a per-investor basis with a compensation limit of HK\$150,000 for trading securities and futures contracts respectively.

According to section 236 of the SFO, the scope of the compensation fund currently covers intermediaries licensed for Type 1 (dealing in securities), Type 2 (dealing in futures contracts) or Type 8 (providing securities margin financing) regulated activities. We are of the view that the compensation coverage should be extended to cover ATS activities and accordingly ATS providers. This will mean that special funding arrangements may be needed in relation to ATS trading for the coverage to be extended.

### **E. Mitigation of Counterparty Risks**

In addition to market risks and operational risks, ATS activities also carry counterparty risks which occur on the opposite side of the trade. In the context of ATS activities, the counterparty risks stem from the nature of the service as it involves a medium through which participants

in the market trade with counterparties. The measurement of counterparty risks depends on the exposure to the failure of a counterparty.

The general public will have expectation that the ATS providers that they use are financially stable relying on the fact that they are authorised by the SFC. It is thus of paramount importance for the SFC to ensure that the counterparty risks of ATS providers are properly assessed and mitigated by requiring them to demonstrate that effective contingency and risk assessment measures are in place.

### **F. Providing Online Frequently Asked Questions (FAQ) Section**

In respect of the draft revised Guidelines, a few examples illustrating how the ATS Guidelines may be applied in practice were set out in Section G.

The section contains 7 hypothetical examples currently, covering aspects of ATS for trading or clearing OTC derivatives, interests in CIS and structured products. We believe that the list of examples could be constantly updated or amended upon feedback from members of the public or new developments in the industry.

In order to allow better flexibility, we suggest that Section G should be included in the Frequently Asked Questions (“FAQ”) section on the SFC’s website rather than in the ATS Guidelines document. The SFC may also consider adding into the FAQ some common issues raised by respondents during consultation.

### **G. Easier Access to Online Records of Part III ATS Providers**

At present, the register of authorized Part III ATS provider is accessible on the SFC website via the following steps (Home -> Regulatory functions -> Market infrastructure & trading -> Approved or authorized entities Register of Automated Trading Services Authorized Under Part III of the Securities and Futures Ordinance).

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We propose that the register of Part III ATS providers shall be more accessible similar to the Public Register of Licensed Persons and Registered Institutions which can be accessed directly from the home page of SFC's website.

In addition, the online register currently only contains three columns of basic information, namely business address, conditions for authorization, and authorization date. In comparison with that available of Licensed Persons and Registered Institutions, this seems significantly minimal.

Therefore, we also propose that the online database provides additional information.

## Conclusion

The ATS Guidelines have not been amended after its introduction tracing back to 2003 which is more than 12 years ago. In light of the enactment of the Securities and Futures (Amendment) Ordinance 2014 which envisaged the regulatory framework regarding the OTC derivatives market in Hong Kong, this is undoubtedly the perfect time for a revised ATS Guidelines to come in place so that the newly introduced changes are properly reflected. We support the SFC's initiative in exploring the possibility of amending the ATS Guidelines. We hope that the proposed amendment would be of assistance to the regulation of ATS providers and SFC could facilitate prompt regulatory actions in the future.

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