

SFC proposes amendments to regulation of automated trading services guidelines

On 20 November 2015 the Securities and Futures Commission (SFC) published its Consultation Paper on Proposed Amendments to the Guidelines for the Regulation of Automated Trading Services (Consultation Paper). The original Guidelines for the Regulation of Automated Trading Services were first published in 2003 (2003 Guidelines) to complement the regulation of automated trading services (ATS) under the Securities and Futures Ordinance (SFO).

The proposed changes do not constitute a wholesale change of the existing regime, but are necessary to accommodate the new over-the-counter (OTC) derivatives regulatory regime being introduced in Hong Kong. Comments to the Consultation Paper are due by 31 December 2015.

Background

Currently ATS providers are operating under two regimes:

(i) Part V of the SFO, where persons may seek a Type 7 licence (or registration in the case of Hong Kong authorized banks) to provide ATS. This is typically the case for intermediaries with a Hong Kong presence who wish to add ATS facilities to their other dealing services for their clients; and

(ii) Part III of the SFO, where persons may seek an authorization

to provide ATS. Such providers usually offer ATS services as their core function and offer traditional exchange or clearing house facilities to their clients without necessarily carrying on a business in Hong Kong.

The number of ATS providers authorized under Part III of the SFO, who are pre-dominantly operators of overseas regulated exchanges and trading facilities are on the rise since the inception of the ATS regime. The Part III regime is the focus of this Consultation Paper.

Key issues

- The SFC's proposals to its ATS guidelines mainly address the new OTC derivatives regime
- When mandatory clearing is implemented (expected in mid 2016), market participants who currently provide ATS for clearing OTC derivative transactions need to be authorized ATS providers to continue to provide such services
- Overseas CCPs who wish to provide services as a designated CCP under the mandatory clearing regime will need to become authorized ATS providers under Part III of the SFO

The key changes proposed

The SFC notes that a review of the 2003 Guidelines is needed to reflect the regulatory and other developments over the past 12 years.

A copy of the draft revised Guidelines for the Regulation of ATS (Draft Guidelines) can be found in the appendix of the Consultation Paper.

The key proposed changes relate to the following.

1. OTC derivatives regulations

In line with the global efforts to reform the OTC derivatives market, the Securities and Futures (Amendment) Ordinance 2014 (Amendment Ordinance) was enacted in March 2014. Amongst other things the Amendment Ordinance:

- (a) expands the definition of ATS to cover services for the trading or clearing of OTC derivatives;
- (b) expands the licensing regime under the SFO to cater for OTC derivatives transactions. In particular, the scope of Type 7 regulated activity (providing ATS) and Type 9 regulated activity (asset management) will be expanded to cover OTC derivative transactions. Two new regulated activities, namely 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) are introduced;
- (c) introduces a mandatory clearing obligation which stipulates that certain standardized OTC derivative transactions will have to be cleared through a designated CCP that is either a recognized clearing house (RCH) or an ATS provider authorized under Part III of the SFO; and
- (d) introduces a mandatory trading obligation which stipulates that certain OTC derivatives transactions may only be traded on designated trading platforms that are either a recognized exchange company (REC) or an ATS provider authorized under Part III of the SFO.

The new OTC derivatives regime will be rolled out in phases – mandatory clearing is expected to be implemented in mid 2016 (but for only a limited number of persons and products) along with the clearing leg definition of ATS; mandatory trading and the expanded licensing regime will follow at a later stage.

When mandatory clearing comes into force, CCPs who currently provide, or market, clearing services for OTC derivatives transactions to persons in Hong Kong will need to be authorized under Part III of the SFO. Overseas CCPs who wish to provide services as a designated CCP for the purposes of the mandatory clearing regime will also need to become authorized ATS providers under Part III of the SFO.

The recognition of overseas CCPs will be critical to the compliance strategy of many market participants, particularly international dealers, who are already clearing members of overseas CCPs (or have established indirect access).

The Draft Guidelines provide guidance for applicants who intend to provide services for clearing OTC derivatives transactions and who seek CCP designation.

2. Alignment with international standards

The Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO) published the Principles for Financial Market Infrastructures (PFMI) in April 2012. The PFMI sets regulatory standards for financial market infrastructures (FMIs) including CCPs.

It is the expectation of the SFC for RCH and authorized ATS providers to demonstrate compliance with the PFMI. For RCH, the SFC published Guidelines on the Application of the CPSS-IOSCO Principles for Financial Market Infrastructures in 2013. For authorized ATS providers, the Draft Guidelines now make it clear that overseas CCPs are expected to comply with the core standards and best practices of the PFMI requirements.

The SFC is proposing to reorganize and expand the current 7 core standards to 9 core standards to ensure alignment with relevant PFMI requirements for CCPs. In particular, two new standards are introduced: (a) Standard 4 on governance (incorporating the previous standard on "fitness"), where processes such as clear lines of reporting, proper arrangements for handling conflicts of interest and adequate internal control procedures are introduced; and (b) Standard 5 on access and participation, where an ATS provider is expected to have objective, risk based and transparent access criteria, and requirements which permit fair and open access where circumstances permit.

3. Updating the guidelines to provide better transparency

- (a) Operations of a stock market, futures market or CCP

The SFC notes that the provision of ATS may also constitute the operation of a "stock market", "future market" or "clearing house" under a separate regulatory regime. The SFC sets out the matters ATS providers should take into account when providing such ATS:

- Person seeking authorization to provide ATS, and whose ATS are for the trading of securities, should consider whether their proposed services might contravene section 19(1)(a) of the SFO. Section 19(1)(a) of the SFO prohibits any person, other than the Stock Exchange of Hong Kong Limited (or its holding company or fellow subsidiary) from operating a stock market in Hong Kong.
- Persons seeking to operate a futures market in Hong Kong may either apply to become an REC or they may apply for authorization to provide ATS under Part III of the SFO. Persons wishing to operate an exchange-like platform should take into account the differences between the two regimes - the SFC has identified five major differences between the two regimes in its Draft Guidelines.
- In the case of "clearing houses", persons seeking to operate a CCP in Hong Kong may either apply to become an RCH or apply for authorization to provide ATS under Part III of the SFO. The main difference between the two is that RCH provides for a wide range of insolvency override protections while Part III authorization provides limited protection only. The SFC will generally expect CCPs based in Hong Kong to apply to become an RCH. The ATS route will be available only to overseas CCPs that enjoy the necessary insolvency override protections under the laws of their home jurisdictions. Based on the SFC's explanation in the consultation paper on introducing mandatory clearing and expanding mandatory reporting (published September 2015), it may require an amendment to the definition of "market contract" in the SFO in order to extend insolvency override protections to overseas CCPs using the ATS route. It is difficult at this point to predict when such an amendment to primary legislation can or will be made. In the meantime, while overseas CCPs are likely to enjoy the necessary insolvency override protections in their home jurisdiction, the absence of full insolvency override protection in Hong Kong may potentially affect the ability for overseas CCPs to apply their

default management rules to Hong Kong incorporated clearing members.

- (b) Regulation of offers of investments under Part IV of the SFO

Under Part IV of the SFO, offers of investments may be subject to certain authorizations of the SFC. ATS providers authorized under Part III of the SFO are permitted to offer and market their trading or clearing services to persons in Hong Kong. However such ATS providers would still be subject to the offers of investments regime under Part IV of the SFO. The SFC's Draft Guidelines include a new section highlighting the need to ensure compliance.

4. Housekeeping amendments

- (a) Guidance on ATS under Part V registration removed

Under Part V of the SFO, ATS constitutes Type 7 regulated activity (providing ATS). Since detailed information on the licensing procedures for persons wishing to be licensed or registered for Type 7 regulated activities under Part V of the SFO is already set out in the SFC's Licensing Information Booklet, the SFC is proposing to remove the section concerning the procedures for applying Type 7 regulated activities under Part V of the SFO from the 2003 Guidelines.

- (b) Updating list of illustrative examples

The SFC has updated the list of illustrative examples providing scenarios on ATS for trading or clearing OTC derivatives, interests in collective investment schemes and structured products.

Conclusion

The proposed Draft Guidelines do not constitute a wholesale change of the existing regime. The changes are necessary to adjust the existing ATS framework to accommodate the new OTC derivatives regulatory regime which is being introduced in Hong Kong. As such, there should be few changes for ATS providers which only provide automated trading services in relation to securities and futures contracts. However, the new regime will encompass a much wider variety of ATS providers – such as traditional overseas exchanges, overseas CCPs, and ATS trading OTC derivatives contracts. The SFC acknowledges this point by its intention to take a pragmatic approach to regulating the provision of ATS, in order to ensure regulation that is commensurate with the functions

and risks, creates a level playing field and is in line with international standards.

Timing

The SFC welcomes comments to the Consultation Paper by 31 December 2015. The SFC hopes to finalize the new

guidelines by the first quarter of 2016. The SFC aims to work towards implementing the revised guidelines at the same time that the subsidiary legislation for mandatory clearing is implemented, which is expected to be mid 2016.

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