

**Subcommittee on Draft Subsidiary Legislation to be made under
the Securities and Futures Ordinance**

Securities and Futures (Recognized Counterparty) Rules

This paper sets out the proposals of the Securities and Futures Commission (SFC) to prescribe institutions which will qualify as recognized counterparties defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (SFO) (5 of 2002).

Proposal

2. The SFC proposes to make the Securities and Futures (Recognized Counterparty) Rules, now in draft at **Annex 1**, under section 397(1) of the SFO.

Power to make the Rules

3. The term “recognized counterparty” is defined in Part 1 of Schedule 1 to the SFO in the following terms -

““recognized counterparty” (認可對手方) means -

- (a) an authorized financial institution;
- (b) in relation to a particular transaction conducted by a corporation licensed for Type 3¹ regulated activity, another corporation which is also so licensed; or
- (c) an institution prescribed by rules made under section 397 of this Ordinance for the purposes of this definition as a recognized counterparty.”

4. Paragraph (c) of the definition provides that other institutions prescribed by rules made under section 397 may qualify as recognized counterparties. Paragraph (o) of section 397(1) empowers the SFC to

¹ Type 3 regulated activity is leveraged foreign exchange trading under Part 1 of Schedule 5 to the SFO.

make rules to “prescribe, specify or provide for any matter which this Ordinance provides is, or may be, prescribed, specified or provided for by rules made under this section.” The Legal Services Division of the SFC and the Department of Justice have been consulted on the *vires* of the draft Rules. The advice is that the draft Rules would be *intra vires* if made as drafted.

Major features of the draft Rules

5. An institution prescribed as a “recognized counterparty” under the draft Rules would not be considered a client² of a corporation licensed in Hong Kong for leveraged foreign exchange trading, and the regulatory requirements in relation to its clients (e.g. issuance of contract notes and statement of accounts) would not be applicable to such recognized counterparties. In addition, certain requirements under the financial resources rules to be made under the SFO would not be applicable to dealings of a licensed leveraged foreign exchange trader with recognized counterparties.

6. The draft Rules would basically preserve the SFC’s criteria in considering past applications under its equivalent power to designate a “recognized counterparty” under section 2 of the Leveraged Foreign Exchange Trading Ordinance (Cap. 451). The draft Rules prescribe five types of institutions that are recognized counterparties -

- (a) a corporation licensed for dealing in futures contracts that deals in currency futures contracts on any specified futures exchange, as set out in Part 2 of Schedule 1 to the SFO;
- (b) a futures contracts dealer that is regulated in any specified jurisdiction as set out in Schedule 1 to the draft Rules and that deals in futures contracts on a specified futures exchange (except where such dealer ceases to be authorized to carry out such dealing as a result of the action of the authority or regulatory organization that regulates it in its home jurisdiction);
- (c) a bank that is incorporated in any specified jurisdiction and regulated by a specified bank regulator in that jurisdiction, as set out in Schedule 1 to the draft Rules (except where the

² Definition of “client” in Part 1 of Schedule 1 to the SFO.

bank ceases to be authorized to operate as a bank as a result of the action of the specified bank regulator);

- (d) a corporation that has issued debt instruments which continue to attract a qualifying credit rating (as defined in Part 5 of Schedule 1 to the SFO); and
- (e) an institution in respect of which the SFC is satisfied that the recognition is appropriate and that it would not prejudice the interests of the investing public, and which is specified in Schedule 2 to the draft Rules.

7. The SFC considers that by enabling leveraged foreign exchange traders to treat as recognized counterparties a reasonable range of institutions, which facilitates the conduct of their business, the draft Rules would be consistent with the SFC's regulatory objectives in sections 4(a) and (c) of the SFO "to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry" and "to provide protection for members of the public investing in or holding financial products" respectively. The type of institutions specified in the draft Rules is drawn in a rigorous manner to ensure that only those institutions that are appropriate will qualify.

Public consultation

8. The SFC released a consultation document and an exposure draft of the Rules on 30 November 2001 for comment by the public. A total of 6 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate. We attach the following documents for Members' reference -

- (a) Consultation Document on the draft Rules, at **Annex 2**, which sets out the underlying policy, together with the exposure draft of the Rules. Members would appreciate that certain proposals in the Consultation Document and the exposure draft of the Rules may have become outdated as the proposals and draft Rules were refined in the light of the comments received during the consultation period. The draft Rules as revised are at Annex 1 for Members' consideration; and

- (b) Consultation Conclusion and Summary of Comments and SFC's Responses, at **Annex 3**, which sets out the conclusions from the consultation and the SFC's responses to the comments received in the form of a table. A list of respondents is attached to the Consultation Conclusion.

Way forward

9. Subject to Members' views, the SFC will proceed to make the Rules under the authority vested in it and publish the Rules so made in the Gazette for tabling before the Legislative Council in the normal manner. The intention is that the Rules shall come into operation on the commencement of the SFO.

Securities and Futures Commission
Financial Services Bureau
22 April 2002

DRAFT

Annex 1

SECURITIES AND FUTURES (RECOGNIZED COUNTERPARTY) RULES

(Made by the Securities and Futures Commission
under section 397(1) of the Securities and
Futures Ordinance (5 of 2002))

1. Commencement

These Rules shall come into operation on the day appointed for the commencement of Part XVI of the Securities and Futures Ordinance (5 of 2002).

2. Interpretation

In these Rules, unless the context otherwise requires -

"currency futures contract" (貨幣期貨合約) means a futures contract in respect of any currency;

"dealing in futures contracts" (期貨合約交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

"equivalent corporation" (等同法團) means a corporation that -

- (a) carries on business in a specified jurisdiction in an activity which, if it were carried on in Hong Kong, would constitute dealing in futures contracts, under an authorization (however described) by an authority or regulatory organization in that jurisdiction; and
- (b) has and maintains shareholders' funds of not less than \$30,000,000 or its equivalent in any foreign currency as calculated by -

- (i) adding together the corporation's -
 - (A) issued and paid up share capital;
and
 - (B) retained profits and reserves with
aggregate net credit balances; and
- (ii) subtracting from the sum calculated under
paragraph (i) the corporation's
accumulated losses and reserves with
aggregate net debit balances;

"specified bank regulator" (指明銀行規管當局) means -

- (a) an authority specified in column 3 of Schedule 1 as
an authority in a specified jurisdiction set out
opposite to it in column 2 of Schedule 1 with
responsibility for regulating banks in that
jurisdiction; or
- (b) any successor of such authority;

"specified jurisdiction" (指明司法管轄區) means a jurisdiction
specified in column 2 of Schedule 1.

3. Institutions that are recognized counterparties

For the purposes of paragraph (c) of the definition of
"recognized counterparty" in Part 1 of Schedule 1 to the Ordinance,
the following institutions are recognized counterparties -

- (a) a corporation licensed for dealing in futures contracts that deals in currency futures contracts on any specified futures exchange;
- (b) an equivalent corporation that deals in currency futures contracts on any specified futures exchange, except where such corporation ceases to be authorized to carry out such dealing as a result of the action of the authority or regulatory organization that regulates it in the specified jurisdiction in which it is incorporated and regulated;
- (c) a bank that is incorporated in a specified jurisdiction and regulated by a specified bank regulator in that jurisdiction, except where the bank ceases to be authorized to operate as a bank as a result of the action of the specified bank regulator;
- (d) a corporation that has issued debt instruments which continue to attract a qualifying credit rating; and
- (e) an institution -
 - (i) in respect of which the Commission is satisfied that recognition as a counterparty -
 - (A) is appropriate; and

- (B) would not prejudice the interests of
the investing public; and
- (ii) which is specified in Schedule 2.

SCHEDULE 1

[s. 2]

SPECIFIED JURISDICTIONS AND
SPECIFIED BANK REGULATORS

Item	Specified Jurisdiction	Specified Bank Regulator
1.	Australia	Australian Prudential Regulation Authority
2.	Canada	Office of the Superintendent of Financial Institutions
3.	The Federal Republic of Germany	Bundesaufsichtsamt für das Kreditwesen
4.	The French Republic	La Commission Bancaire
5.	Japan	Financial Services Agency
6.	The Swiss Confederation	Eidgenössische Bankenkommission
7.	The United Kingdom of Great Britain and Northern Ireland	Financial Services Authority
8.	The United States of America	Board of Governors of the Federal Reserve System The Office of the Comptroller of the Currency

SCHEDULE 2

[s. 3(e)]

SPECIFIED INSTITUTIONS THAT ARE RECOGNIZED COUNTERPARTIES

1. Bear Stearns Forex Inc.
2. HSBC Broking Securities (Asia) Ltd.

Chairman,
Securities and Futures
Commission

2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 397(1) of the Securities and Futures Ordinance (5 of 2002). They prescribe certain institutions as recognized counterparties for the purposes of paragraph (c) of the definition of "recognized counterparty" in Part 1 of Schedule 1 to the Ordinance. This means that such an institution would not be a client of a corporation licensed in Hong Kong for leveraged foreign exchange trading.

Consultation Document

The Draft Securities and Futures (Recognized Counterparty) Rules (the “draft Rules”)

Introduction

1. Under section 2 of the Leveraged Foreign Exchange Trading Ordinance (“LFETO”), a recognized counterparty is defined to mean an authorized institution, another licensed leveraged foreign exchange trader (“trader”) or an institution designated in writing by the Securities and Futures Commission (the “SFC”) as a recognized counterparty. As part of our effort to enhance transparency, the last limb of the definition has been amended under Schedule 1 of the Securities and Futures Bill (“Bill”) to read “an institution prescribed by rules made under clause 384 of the Bill for the purposes of this definition as a recognized counterparty”.
2. The qualifying criteria are to be prescribed in the subsidiary and not the primary legislation. Effective regulation depends upon the regulator having the flexibility quickly to address changing market practices and global conditions, by amending the rules rather than the primary legislation.
3. There are controls built into the legislative system, whereby any rules made by the SFC must be subject to negative vetting by the Legislative Council. In addition, the SFC now releases the draft Rules for public consultation.
4. Copies of the consultation document have been sent to all existing traders by post. The public may obtain copies of the consultation document free of charge at the SFC’s office and on the SFC web site at <http://www.hksfc.org.hk>.
5. The SFC invites market participants and interested parties to submit written comments on the draft Rules or to comment on related matters that might have a significant impact upon the draft Rules no later than 29 December 2001. Any person wishing to comment on the draft Rules should, where applicable, provide details of any organisation whose views they represent. In addition, persons suggesting alternative approaches are encouraged to submit proposed text to amend the draft Rules.

The Importance of Recognized Counterparty Status

6. Treatment of an institution as a recognized counterparty has two implications under the existing LFETO:
 - (a) the requirements imposed on the trader in relation to its clients (such as, issuance of contract notes and statements of accounts to clients, segregation of client monies into trust accounts, etc.) are not applicable to an institution that is designated as a recognized counterparty; and
 - (b) under the Leveraged Foreign Exchange Trading (Financial Resources) Rules (“LFET(FR)R”),
 - (i) the positions with a recognized counterparty are excluded in calculating the aggregate gross position for all foreign currencies of a trader; and
 - (ii) a trader is not required to collect 3% margin from its recognized counterparties.

The SFC intends to apply the same concept in the Securities and Futures (Financial Resources) Rules.

7. It is important that only high quality institutions are accepted as recognized counterparties in order not to undermine the effectiveness of the LFET(FR)R.
8. SFC has formulated the draft Rules after informally consulting selected traders. We wish to acknowledge and thank them for their invaluable input.

Background

9. A copy of the draft Rules is attached for reference. The draft Rules are generally based on the major criteria used by the SFC in considering past applications. They take into account the following pertinent factors:
 - (a) regulatory oversight, placing reliance on overseas regulatory systems that are well established with recognizable international standards;

- (b) relevant experience in trading in exchange-traded currency futures contracts, which are the products commonly used for hedging purposes;
 - (c) financial standing (capital base to be compatible with that of a trader); and
 - (d) qualifying credit rating.
10. Besides recognising institutions that meet these characteristics, it is necessary to allow for exceptional cases from time to time. At present, 2 out of the 8 existing recognized counterparties would not automatically qualify under the draft Rules (see Schedule 2 to the draft Rules).

Policy Initiatives

11. In addition to authorised institutions and traders that would automatically qualify as recognized counterparties under the Bill, four other types of institutions will also qualify automatically in the draft Rules:
- (a) a corporation licensed for dealing in futures contracts that deals in currency futures contracts on any specified futures exchange (as defined in Part 2 of Schedule 1 of the Bill, which is attached for ease of reference);

[Note: Exchange participants of Hong Kong Futures Exchange Limited will fall under this category.]
 - (b) a futures dealer regulated in any specified jurisdiction (excluding any dealer which the relevant authority has ordered to cease operation) that deals in currency futures contracts on any specified futures exchange and has shareholders' funds of not less than Hong Kong dollars \$30,000,000 or its equivalent. The specified jurisdictions consist of Australia, Canada, Germany, France, Japan, Switzerland, UK and US (see Schedule 1 to the draft Rules);
 - (c) a bank carrying on deposit taking business other than a merchant bank or an investment bank (excluding any bank which the relevant authority has ordered to cease operation) which is incorporated and regulated in any specified jurisdiction; and

- (d) a corporation that has issued debt instruments which continue to attract a qualifying credit rating (as defined in Part 4 of Schedule 1 of the Bill, being a Moody's Investors Service rating of A3 or above for long term debt or Prime-3 or above for short term debt or a Standard & Poor's Corporation rating of A or above for long term debt or A-3 or above for short term debt).
12. In addition, there is the fifth category of institutions which the SFC believes should qualify as recognized counterparties but which do not fit into any of the four prescribed categories mentioned above. Such institutions will be listed in Schedule 2 to the Rules. In the event that the list needs to be changed by way of addition or deletion over time, the Schedule can be amended accordingly. An example will be an unrated central bank that is not in a specified jurisdiction.
13. **Please note that the names of the commentators and the contents of their submissions may be published on the SFC web site and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation document.**
14. **You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.**
15. Written comments may be sent

By mail to: SFC Recognized Counterparty Rules
12/F, Edinburgh Tower
The Landmark
15 Queen's Road, Central
Hong Kong

By fax to: (852) 2523 4598

By on-line submission: <http://www.hksfc.org.hk>

By e-mail to: recognized_counterparty_rules@hksfc.org.hk

Personal Information Collection Statement

1. This Personal Information Collection Statement (“PICS”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection by the Securities and Futures Commission (“SFC”), what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the PDPO.

Purpose of Collection

2. The Personal Data provided in your submission to the SFC in response to the Consultation Document on The Draft Securities and Futures (Recognized Counterparty) Rules (“the Consultation Document”) may be used by the SFC for one or more of the following purposes:
 - to administer the relevant Ordinances, rules, regulations, codes and guidelines made or promulgated pursuant to the powers vested in the SFC
 - for the purposes of performing the SFC’s statutory functions under the relevant Ordinances
 - for research and statistical purposes
 - other purposes permitted by law

Transfer of Personal Data

3. Personal Data may be disclosed by the SFC to the members of the public in Hong Kong and elsewhere, as part of the public consultation on the Consultation Document. The names of persons who submit comments on the Consultation Document together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the SFC web site and in documents to be published by the SFC throughout and at the conclusion of the consultation period.

Access to Data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance, Cap 486 (“PDPO”)

provided in your submission on the Consultation Document. The SFC has the right to charge a reasonable fee for processing any data access request.

Enquiries

5. Any enquiries regarding the Personal Data provided in your submission on the Consultation Document, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer,
Securities and Futures Commission
12/F, Edinburgh Tower, The Landmark
15 Queen's Road Central Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

PART 2

SPECIFIED FUTURES EXCHANGES

1. Amsterdam Exchange NV
2. Australian Stock Exchange
3. Chicago Board of Trade
4. Chicago Board Options Exchange
5. Chicago Mercantile Exchange Inc.
6. Commodity Exchange, Inc. (New York)
7. Eurex
8. Hong Kong Futures Exchange Limited
9. Korea Stock Exchange
10. London International Financial Futures and Options Exchange
11. London Metal Exchange
12. Marche a Terme International de France
13. Marche des Options Negociables de Paris
14. New York Cotton Exchange, Inc.
15. New York Futures Exchange
16. New York Mercantile Exchange
17. New Zealand Futures and Options Exchange
18. OM Stockholm Exchange
19. Osaka Securities Exchange
20. Pacific Stock Exchange
21. Philadelphia Stock Exchange
22. Singapore Exchange Derivatives Trading Limited
23. Sydney Futures Exchange, Ltd.
24. Tokyo Grain Exchange
25. Tokyo International Financial Futures Exchange
26. Tokyo Stock Exchange
27. Toronto Futures Exchange
28. Winnipeg Commodities Exchange

SECURITIES AND FUTURES (RECOGNIZED COUNTERPARTY) RULES

SECURITIES AND FUTURES (RECOGNIZED COUNTERPARTY) RULES

(Made by the Securities and Futures Commission
under section 384(1) of the Securities and
Futures Ordinance (of 2002)

1. Commencement

These Rules shall come into operation on the day
appointed for the commencement of Part XVI of the Securities
and Futures Ordinance (of 2002).

2. Interpretation

In these Rules, unless the context otherwise requires -

“currency futures contract” (貨幣期貨合約) means a futures
contract in respect of any currency;

“equivalent corporation” (等同法團) means a corporation that -

- (a) is incorporated and regulated in a specified
jurisdiction;

(b) is the equivalent in the specified jurisdiction of a corporation licensed for dealing in futures contracts; and

(c) has and maintains issued and paid up share capital of not less than \$30,000,000 or its equivalent in any other currency as calculated by -

(i) adding together the corporation's -

(A) issued and paid up share capital;

and

(B) retained profits and reserves

with aggregate net credit

balances; and

(ii) subtracting the corporation's

accumulated losses and reserves with

aggregate net debit balances;

"specified jurisdiction" (指明司法管轄區) means a jurisdiction specified in Schedule 1.

3. Institutions that are recognized counterparties

For the purposes of paragraph (c) of the definition of "recognized counterparty" in Part 1 of Schedule 1 to the Ordinance, the following institutions are recognized counterparties -

- (a) a corporation licensed for dealing in futures contracts that deals in currency futures contracts on any specified futures exchange;
- (b) an equivalent corporation that deals in currency futures contracts on any specified futures exchange, except where such corporation ceases to be permitted to carry out such dealing as a result of the action of the authority that regulates it in the specified jurisdiction in which it is incorporated and regulated;
- (c) a bank carrying on deposit-taking business that is incorporated and regulated in a specified jurisdiction, except where the bank -
 - (i) is a merchant bank;
 - (ii) is an investment bank; or

(iii) ceases to be permitted to operate as a bank as a result of the action of the authority that regulates it in the specified jurisdiction;

(d) a corporation that has issued debt instruments which continue to attract a qualifying credit rating; and

(e) an institution -

(i) in respect of which the Commission is satisfied that recognition as a counterparty -

(A) is appropriate; and

(B) would not prejudice the interests of the investing public; and

(ii) which is specified in Schedule 2.

SCHEDULE 1

[ss.2, 3(b), (c)]

SPECIFIED JURISDICTIONS

Australia

Canada

The Federal Republic of Germany

The French Republic

Japan

The Swiss Confederation

The United Kingdom of Great Britain and Northern Ireland

The United States of America

SCHEDULE 2

[s.3(e)]

SPECIFIED INSTITUTIONS THAT ARE RECOGNIZED COUNTERPARTIES

1. Bear Stearns Forex Inc.
2. HSBC Broking Securities (Asia) Ltd.

Chairman,
Securities and Futures
Commission

2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 384(1) of the Securities and Futures Ordinance (of 2002). They prescribe certain institutions as recognized counterparties for the purposes of paragraph (c) of the definition of "recognized counterparty" in Part 1 of Schedule 1 to the Ordinance. This means that such institutions fall within paragraph (b) of the definition of "client" in Part 1 of Schedule 1 to the Ordinance. As a consequence, in connection with trading in leveraged foreign exchange contracts by a corporation licensed for such trading with or on behalf of any such institution, the institution is not considered to be a client of the licensed corporation.

Consultation Document on the Draft Securities and
Futures (Recognized Counterparty) Rules

Consultation Conclusion Report

Securities and Futures Commission
Hong Kong

April 2002

INTRODUCTION

1. On 30 November 2001, the Securities and Futures Commission released ‘Consultation Document on the draft Securities and Futures (Recognized Counterparty) Rules’ (“Consultation Document”). The Consultation Document contained proposed rules to prescribe the qualifying criteria of a recognized counterparty.
2. The consultation period lasted until 29 December 2001. 6 submissions were received.
3. Taking into account of the submissions received, some amendments to the original draft Rules are considered appropriate. The Commission will further amend the draft Rules taking into account the comments received.
4. The purpose of this report is to provide interested persons with an analysis of the main comments raised during the consultation exercise and the rationale for the SFC’s conclusions. *This report should be read in conjunction with the Consultation Document.*

PUBLIC CONSULTATION

Consultation process

5. In addition to the public announcement inviting comments, the Consultation Document was distributed to all licensed leveraged foreign exchange traders (“traders”) and various professional bodies. The Consultation Document was also published on the SFC Internet website.
6. 6 submissions were received from existing traders, professional associations and academics.
7. Comments varied considerably in range and depth, with some making specific recommendations and others seeking clarification.
8. The submissions were carefully considered and amendments were made to the original draft Rules. We have further consulted industry participants for the proposed amendments. The amendments received a high level of acceptance and constituted the basis for the revised Rules.

Consultation conclusion

9. The following major changes to the qualifying criteria of a recognized counterparty have been made in paragraph 3(c) of the draft Rules:

- (1) A bank, which is incorporated in a specified jurisdiction and is regulated by a relevant banking regulatory authority, will be a recognized counterparty. To elaborate further on the criteria for regulatory oversight over a bank, we have included in Schedule 1 to the Rules the main banking regulatory authorities in the corresponding specified jurisdictions.
- (2) We have reconsidered the need to exclude “merchant bank” and “investment bank” and concluded that such exclusion is superfluous given that “bank” is already defined in Schedule 1 to the Securities and Futures Ordinance to mean:

“any institution carrying on business similar to –

- (a) the banking business within the meaning of the Banking Ordinance (Cap. 155) as carried on by an authorized financial institution; or
- (b) the business of taking deposits within the meaning of that Ordinance as carried on by an authorized financial institution,

whether it is an authorized financial institution or not”.

10. Some amendments have also been made to the definition of “equivalent corporation” in order to avoid any unnecessary ambiguity as to our qualifying criteria. These amendments, however, do not constitute any change in our policy intent.

SUMMARY OF COMMENTS AND SFC’S RESPONSES

11. A summary of comments received on the draft Rules and the corresponding response of the Commission are set out in the Appendix.

EFFECTIVE DATE AND TRANSITIONAL ARRANGEMENTS

12. The Securities and Futures (Recognized Counterparty) Rules will become effective on the day appointed for the commencement of Part XVI of the Securities and Futures Ordinance.

**Summary of comments received on the Draft
Securities and Futures (Recognized Counterparty) Rules**

	Section reference	Details of the Rules	Respondent's comments	SFC's response
<i>General comments</i>				
1.	-		[Dr Louis Cheng] It appears that the reason and the motivation for broadening the qualification of recognized counterparties in the new legislation are not clearly stated. In order to allow the public to better understand why the SFC is doing this, a paragraph explaining the reasons should be added.	The reasons and motivation for broadening the qualification of recognized counterparty have already been set out in the consultation document, which are: <ul style="list-style-type: none"> • To enhance transparency (<i>paragraph 1</i>); and • To allow the SFC to have the flexibility to quickly address changing market practices and global conditions, by amending the rules rather than the primary legislation (<i>paragraph 2</i>).
2.	-		[Dr Louis Cheng] The 3% maintenance margin requirement mentioned in point 6(b)(ii) of the consultation document should be "maintained" by the trader and not to be "collected". The amount to be "collected" should be the 5% initial margin requirement and not the 3% maintenance margin.	Noted. No amendment to the draft Rules is necessary.
3.	-		[SHK Forex] The SFC should disclose publicly the list of recognized counterparties that have been designated as such so that relevant party can check before entering into trading arrangement with any prospective counterparty.	When the Rules become effective, institutions which meet the qualifying criteria will automatically become recognized counterparties. The institution which is designated by the Commission as recognized counterparty according to clause 3(e) of the draft Rules will be listed in Schedule 2 of the Rules and will be gazetted.
<i>Specific comments</i>				
4.	3	Qualifying criteria of recognized counterparties	[SHK Forex] The SFC should consider to accept any corporation exempted under section 3(1) of the Leveraged Foreign Exchange Trading (Exemption) Rules as recognized counterparty.	It is not appropriate to treat all exempt corporations as recognized counterparties. We do not see a need to subject exempt corporations to detailed regulations because they only conduct their leveraged foreign exchange trading business on a wholesale level. However, this does not mean that all exempt corporations are financially strong posing

Note : Please refer to the derivation table at the end of this document for cross references to the section numbers under the Securities and Futures Ordinance as gazetted on 28 March 2002.

	Section reference	Details of the Rules	Respondent's comments	SFC's response
				close to no default risk to our licensed traders.
5.	3 (c)	<p>According to paragraph 3(c) of the draft Rules, the following institution is a recognized counterparty:</p> <p>(c) a bank carrying on deposit-taking business that is incorporated and regulated in a specified jurisdiction, except where the bank –</p> <ol style="list-style-type: none"> i. is a merchant bank; ii. is an investment bank; or iii. ceases to be permitted to operate as a bank as a result of the action of the authority that regulates it in the specified jurisdiction. <p>The specified jurisdictions are Australia, Canada, The Federal Republic of Germany, The French Republic, Japan, The Swiss Confederation, The United Kingdom of Great Britain and Northern Ireland and The United States of America.</p>	<p>[SHK Forex] The draft Rules only include banks regulated in specified jurisdictions, which are set out in Schedule 1 as recognized counterparties. However, Singapore or New Zealand or some other OECD countries are not included as specified jurisdictions. In addition, branches of those banks may be excluded.</p>	<p>The SFC considers that Schedule 1 to the draft Rules has already covered all major countries in which existing recognized counterparties are incorporated.</p> <p>A bank, which is incorporated in a specified jurisdiction and is regulated by a relevant banking regulatory authority, will be a recognized counterparty. To elaborate further on the criteria for regulatory oversight over a bank, we have included in Schedule 1 the main banking regulatory authorities in the corresponding specified jurisdictions.</p> <p>We do not see any need specifically to include branches of a bank as they are of the same commercial entity.</p>
6.	3(c)		<p>[LSHK and Wocom] The terms “merchant bank” and “investment bank” are not defined in either the draft Rules or the Securities and Futures Bill. There are no clear criteria to assess whether a bank can be regarded as a merchant bank or investment bank.</p> <p>It is not clear why the SFC wishes to exclude merchant banks or investment banks from being treated as recognized counterparties.</p>	<p>We have reconsidered the need to exclude “merchant bank” and “investment bank” and concluded that such exclusion is superfluous given that “bank” is already defined in Schedule 1 to the Securities and Futures Ordinance to mean</p> <p>“any institution carrying on business similar to –</p> <ol style="list-style-type: none"> (a) the banking business within the meaning of the Banking Ordinance (Cap. 155) as carried on by an authorized financial institution; or (b) the business of taking deposits within the meaning of that Ordinance as carried on by an authorized financial institution, <p>whether it is an authorized financial institution or not”.</p>

	Section reference	Details of the Rules	Respondent's comments	SFC's response
				Hence, paragraph 3(c) of the Rules is revised as follows: “a bank that is incorporated in a specified jurisdiction and regulated by a specified bank regulator in that jurisdiction, except where it ceases to be authorized to operate as a bank as a result of the action of the specified bank regulator;”
7.	3 (d)	<p>According to paragraph 3(d) of the draft Rules, the following institution is a recognized counterparty:</p> <p>(d) a corporation that has issued debt instruments which continue to attract a qualifying credit rating.</p>	[Dr Louis Cheng] The credit rating for corporation changes from time to time. The SFC should better define the condition “which continue to attract a qualifying credit rating”. Also, certain guideline might be required in order to determine when a corporation would be or cease to be treated as a recognized counterparty.	<p>A licensed trader has the responsibility to monitor the credit rating of its recognized counterparty. Once the credit rating has been downgraded to below the required level, the licensed trader should immediately cease to treat the relevant corporation as a recognized counterparty.</p> <p>“Qualifying credit rating” is defined in Part 4 of Schedule 1 to the Bill. SFC may, by notice published in the gazette, amend the Schedule to reflect changes of qualifying rating in view of market conditions.</p>
8.	3 (e)	<p>According to paragraph 3(e) of the draft Rules, the following institution is a recognized counterparty:</p> <p>(e) an institution -</p> <p>(i) in respect of which the Commission is satisfied that recognition as a counterparty is appropriate; and would not prejudice the interests of the investing public; and</p> <p>(ii) which is specified in Schedule 2.</p>	[Dr Louis Cheng] The SFC does not specify the criteria for the category in paragraph 3(e) of the draft Rules.	The SFC needs flexibility to grant relief where particular circumstances and anomalous cases do not come within the main categories but it is still appropriate to grant recognition as a counterparty. The concept is little different from the modification powers provided to the SFC in clause 131 of the Securities and Futures Bill.

List of Respondents

Date received	Respondent
28 December 2001	The Law Society of Hong Kong (“LSHK”)
28 December 2001	Dr Louis Cheng, Associated Professor of the Finance Department of Business Studies of The Hong Kong Polytechnic University (“Dr Louis Cheng”)
14 December 2001	Sun Hung Kai Forex Limited (“SHK Forex”)
6 December 2001	Wocom Foreign Exchange Co. Ltd (“Wocom”)
<i>Respondents with no specific comments on the Rules</i>	
3 January 2002	Hong Kong Association of Banks
17 December 2001	Hong Kong Bar Association

Derivation Table

Clause/Schedule in the Securities and Futures Bill	Section/Schedule in the Securities and Futures Ordinance
131	134
Schedule 1, Part 4	Schedule 1, Part 5