

[Response to enquiries from Members of the Legislative Council]

On 18 May 2013, the SFC announced that it had withdrawn the authorization to provide automated trading services (**ATS**) previously granted to Hong Kong Mercantile Exchange Limited (**HKMEx**). The SFC issued a further statement on 21 May 2013. (Copies of both press releases are attached at **Annex 1** for Members' reference.)

As indicated in the SFC's second press release of 21 May 2013, the SFC has initiated an investigation into suspected irregularities in the financial affairs of HKMEx. This investigation is still continuing. Separately, certain issues were also referred to the Commercial Crimes Bureau. Given the SFC and CCB investigations remain afoot, it is not appropriate to make any other comment.

The SFC has however provided the following general information regarding its oversight of ATS providers, which it hopes may be of assistance to legislators.

What is an ATS provider

1. An ATS provider is someone who provides an electronic platform on which financial products may be traded or cleared.
2. Under the Securities and Futures Ordinance (**SFO**), an ATS provider must be either licensed under Part V, or authorized under Part III, of that ordinance.
3. In practice, and as a general principle –
 - o The Part V regime applies to brokers who wish to offer ATS facilities to their clients as part of their brokerage service. In such cases, the provision of ATS is essentially incidental to their provision of brokerage services. Such persons are required to be licensed with the SFC as dealers and as ATS providers¹, and thus regulated under the SFO as licensed persons.
 - o The Part III regime applies to persons who are essentially platform operators, and hence more akin to exchange operations. They offer ATS as a separate service, and not as part of other services that may be offered. They also offer ATS to a wider range of persons (as opposed to an existing group of clients to whom they are providing other services).
4. It is not appropriate to make direct comparisons between ATS providers who are authorized under Part III and those that are licensed under Part V since the functions and operations of the two are quite different. In particular –
 - o ATS providers serve as market operators and not as intermediaries, and hence a main area of regulatory focus will be their trading systems.
 - o ATS providers who provide facilities for trading (and do not offer clearing) do not hold client assets.

It follows that the two are regulated differently and under different provisions of the SFO.

¹ Specifically, they are required to be licensed for: (i) either Type 1 or Type 2 regulated activity, and (ii) Type 7 regulated activity.

5. HKMEx was authorized under Part III of the SFO. Other examples of persons authorized under Part III include a number of overseas exchanges and clearing houses such as the Chicago Mercantile Exchange, ICE Futures Europe, ICE Futures US, LCH.Clearnet, etc. (A full list of the ATS providers authorized by the SFC under Part III of the SFO is available on the SFC's website, the link to which is <http://www.sfc.hk/web/EN/regulatory-functions/market-infrastructure-and-trading/approved-or-authorized-entities/register-of-automated-trading-services-authorised-under-part-iii-of-the-sfo/>.)

Regulation of ATS providers

6. The regulation of Part III ATS operations is set out in broad terms in Part III of the SFO, and elaborated in more detail in the SFC's Guidelines for the Regulation of ATS issued under section 95(6) and 399(1) of the SFO (**ATS Guidelines**).
7. The ATS Guidelines set out the principles for regulation and standards of practice that apply to ATS operations – whether they be licensed under Part V or authorized under Part III.
8. In particular, the standards of practice cover the following areas –
 - *Financial resources and risk management:* The financial resources and risk management policies of an ATS provider should comply with appropriate prudential and operational standards.
 - *Operational integrity:* An ATS provider should maintain electronic facilities with adequate security, capacity, and contingency arrangements.
 - *Fitness and properness:* An ATS provider should be a fit and proper person, as established by an authority in Hong Kong or in its home country.
 - *Record keeping obligations:* An ATS provider should keep full records of its ATS operations, including audit trails of ATS activity.
 - *Transparency obligations:* An ATS should provide appropriate levels of transparency in relation to ATS operations and traded products, including where relevant order processing arrangements, transaction execution, settlement arrangements, and operational requirements or rules.
 - *Surveillance obligations:* Surveillance of ATS activity should be performed by the ATS provider, a regulatory authority (including potentially the SFC), or another competent person, and such surveillance should be consistent with relevant market regulation practices in Hong Kong and internationally.
 - *Reporting obligations:* An ATS provider should keep relevant regulatory authorities informed of its ATS operations and traded products and of material changes to those operations.
9. The SFC adopts these standards of practice both when considering applications for ATS authorization, and when conducting its on-going supervision of authorized ATS providers.

10. ATS operations can be quite diverse. In general, the level of regulation of an ATS will be commensurate with the functions it performs and the risks it poses. In addition, a fair and level playing field will be sought so that similar regulation is applied to similar functions. Among other things, the SFC will consider –
 - the nature and extent of each ATS activity,
 - the market participants that might be affected by the ATS,
 - whether retail investors may be involved,
 - whether any systemic risks might arise.
11. The SFC will also have regard to international standards and best practices in considering the regulation of ATS. These include practices recommended by the International Organization of Securities Commissions and the Bank for International Settlements. They also include the practices of regional markets and of other international financial centres.
12. The ATS Guidelines discuss each of the standards of practice for ATS in greater detail. In relation to financial resources requirements, the ATS Guidelines note that an ATS authorised under Part III typically does not act as a trading counterparty nor hold clients' securities and funds. They also note that in determining the application of the financial resources standard, the SFC will take into account the matters noted in paragraphs 10 and 11 above, with a view to ensuring that the ATS provider has the resources needed for the proper performance of its business activities. As to what constitutes sufficient financial resources, key considerations will include the projected expenditure of the ATS operation from time to time, which in turn will be affected by the size and characteristics of the trading platform and the markets traded on the platform.
13. The ATS Guidelines are available on the SFC's website, the link to which is http://en-rules.sfc.hk/en/display/display_main.html?rbid=3527&element_id=193.

Authorized ATS providers vs recognized exchange companies

14. Under the SFO, a person wishing to operate a futures market may do so either as a recognized exchange company (**REC**) or as an authorized ATS provider.
15. The main differences between an authorized ATS and an **REC** are as follows –
 - The REC regime is set out in the SFO only, whereas the ATS regime is set out in the SFO and in the **ATS Guidelines** (elaborated in greater detail above).
 - The ATS regime has been intentionally designed to allow requirements to be calibrated to the particular features and characteristics of the ATS concerned. This is necessary as ATS operations can vary significantly in nature, function and size.
 - Two particular areas of difference are: (i) recognition as an REC requires prior consultation with the public and the Financial Secretary, whereas authorization of an ATS provider does not, and (ii) there are limitations as to who may

become a controller or minority controller of an REC, whereas there are no such limitations in respect of authorized ATS providers.

16. In considering whether a person wishing to provide a trading platform should become an REC or be authorized as an ATS provider, the SFC will consider, among other things, the nature and extent of the operation, its target participants and investors, its past performance (if any) and whether it is regulated by an acceptable overseas regulator. The SFC will also take into account any views the applicant may have in this regard before determining whether it should be authorized as an ATS provider or become an REC.

Current list of ATS providers

17. There are currently 22 ATS providers authorized by the SFC under Part III of the SFO. The majority of these are overseas regulated exchanges or trading facilities, and most are international financial futures exchanges and commodity futures exchanges (such as Chicago Mercantile Exchange, Chicago Board of Trade, New York Mercantile Exchange, Commodity Exchange and Eurex).
18. The details of all ATS providers authorized under Part III, including the conditions of their authorization, are accessible on the SFC's website, the link to which is <http://www.sfc.hk/web/EN/regulatory-functions/market-infrastructure-and-trading/approved-or-authorized-entities/>.

Previous instances of withdrawals of ATS authorizations

19. Apart from HKMEx, there have been no other cases of authorized ATS providers failing to meet financial requirements. However, there have been previous cases where the SFC has withdrawn an ATS authorization at the request of ATS provider, although this has invariably been for technical reasons such as major system changes and upgrades. An ATS authorization is specific to a particular system, and hence any major system upgrade or change will require SFC authorization.
20. It would be misconceived to compare this regulatory focus on the stability and functionality of an electronic trading system with the regulation of intermediaries carrying out "regulated activities", such as dealing in securities, where the emphasis is on financial resources to protect clients and their assets as well as client conduct rules. In the past, when authorized ATS providers have sought to migrate to new trading systems, they will first apply for the new system to be authorized. Once this is done, and the system migration completed, the ATS provider will surrender its ATS authorization in respect of the old trading system.

HKMEX surrenders its ATS authorization

18 May 2013

Hong Kong Mercantile Exchange Limited (HKMEX) has notified the Securities and Futures Commission (SFC) that it has decided to surrender its authorization to provide automated trading services (ATS) after it considered that the trading revenues have not been sufficient to support its operating expenses (Note 1).

An authorized ATS provider must have financial resources sufficient for the proper performance of its functions and obligations. In the circumstances, the SFC has issued a formal notice of withdrawal of HKMEX's ATS authorization (Note 2).

The withdrawal takes immediate effect and prohibits HKMEX from continuing to provide ATS.

According to HKMEX's market exit plan, positions remaining open as at the close of trading on 16 May 2013 will be financially settled at the settlement price determined by HKMEX and its designated clearinghouse. To ensure that this proceeds in an orderly manner, HKMEX is required to contact its members as soon as practicable.

The SFC will maintain close contact with HKMEX to ensure that the final settlement process is conducted in an orderly manner.

End

Notes:

1. On 26 April 2011, pursuant to section 95(2) of the Securities and Futures Ordinance (SFO), the SFC authorized HKMEX to provide ATS for the purposes of operating a commodities futures market in Hong Kong.
2. The formal notice of withdrawal was issued pursuant to section 98(1) of the SFO.

SFC statement on HKMEX

21 May 2013

The Securities and Futures Commission (SFC) issues the following statement in relation to the withdrawal of the authorization of Hong Kong Mercantile Exchange Limited (HKMEX) as an automated trading services (ATS) provider (Note 1).

- As a result of the recent deterioration in HKMEX's financial position, the SFC notified HKMEX of its intention to withdraw its ATS authorization.
- The Securities and Futures Ordinance (SFO) requires the SFC to give HKMEX an opportunity to respond to the SFC's concerns before a withdrawal decision may be made (Note 2). In accordance with this statutory obligation, the SFC provided HKMEX with time to respond to its concerns. Giving a party procedural fairness is a legal obligation. It is not a sign of any special treatment nor does it mean the SFC was applying a flexible approach in ensuring HKMEX complied with all relevant obligations.
- At the end of this process, HKMEX was unable to satisfy the SFC that it had complied or could comply with the financial condition attached to its authorization (Note 3).
- The SFC proceeded to withdraw the authorization with immediate effect after HKMEX decided not to contest the SFC's decision and agreed to surrender its authorization. This allowed HKMEX to prepare for an orderly wind down of open positions (Note 4).
- The process for winding down HKMEX's trading operations is entirely different from the process that might apply to a troubled broker. HKMEX did not hold client assets so no circularisation was necessary.
- The closing of open positions has been smooth and is now complete. The independent clearing house used by the HKMEX, LCH.Clearnet, has commenced the process of returning collateral relating to HKMEX's market back to clearing members.
- Last Wednesday, the SFC initiated an investigation into suspected irregularities in the financial affairs of HKMEX. In light of the evidence obtained, the SFC referred certain matters to the Commercial Crime Bureau (CCB) as the suspected irregularities are serious ones. For obvious reasons, it was not appropriate to disclose these matters to HKMEX or to the public pending further steps in the investigation. Those steps were taken earlier today. The SFC will continue its investigation and will cooperate fully with the CCB.

The SFC will not make further comment while investigation continues.

End

Notes:

1. The withdrawal was made under section 98 of the Securities and Futures Ordinance.
2. Please see section 98(4) of the SFO.
3. The Notice of Authorization for HKMEX to provide ATS is available on the SFC's website, and sets out the conditions imposed.
4. Please see the SFC's press release dated 18 May 2013.