



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

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

HONG KONG
APRIL 2002

香港
2002年4月

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.

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.

<i>Specific comments</i>				
4.	3	Qualifying criteria of recognized counterparties	<p>[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.</p>	<p>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 close to no default risk to our licensed traders.</p>
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

				<p>(b) the business of taking deposits within the meaning of that Ordinance as carried on by an authorized financial institution,</p> <p>whether it is an authorized financial institution or not”.</p> <p>Hence, paragraph 3(c) of the Rules is revised as follows:</p> <p>“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;”</p>
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>	<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>	<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>	<p>[Dr Louis Cheng] The SFC does not specify the criteria for the category in paragraph 3(e) of the draft Rules.</p>	<p>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.</p>

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