

**Consultation Paper on Draft Guidelines for the Regulation of  
Automated Trading Services**

Securities and Futures Commission  
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## A. Introduction

1. The SFC intends to publish Guidelines to set out principles, procedures, and standards in relation to authorization of persons by the SFC for providing “automated trading services” (or ATS). The Guidelines would become effective after enactment of proposed legislation for the regulation of automated trading services, which can be found in the Securities and Futures Bill (the Bill) in particular Part V and Part III, Division 7. The Guidelines will be published in compliance with clause 95(5) of the Bill. This Consultation Paper sets out draft SFC Guidelines and seeks comments from interested persons. We prepared this Paper under the guidance of an SFC ATS Working Group comprising of market practitioners (see Appendix 1).
2. The Bill’s Schedule 6, Part 2 defines ATS as follows:

“**automated trading services**” means services provided by means of electronic facilities, not being facilities provided by a recognized exchange company or a recognized clearing house, whereby –

- (a) offers to sell or purchase securities or futures contracts are regularly made or accepted;
- (b) persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales or purchases of securities or futures contracts; or
- (c) transactions resulting from the activities referred to in paragraph (a) or (b), or transactions effected on, or subject to the rules of, a stock market or futures market may be novated, cleared, settled, or guaranteed,

but does not include such services provided by a corporation operated by or on behalf of the Government.

## Part V of the Bill

3. **The Bill provides for the regulation of ATS in Part V and Part III. Under Part V, ATS constitute one of nine regulated activities (i.e. Type 7). Clause 114 generally prohibits a person from carrying on a business in a regulated activity unless:**
  - **the person is licensed by the SFC for that activity;**
  - **the person is an authorized financial institution exempt under clause 118 for that activity; or**
  - **in the case of Type 7 ATS activity, the person is authorized by the SFC under Part III, clause 95 for ATS activity.**
4. Where a person is licensed under Part V, all of the provisions of the Bill affecting licensed persons will normally apply. These include, for examples, licensing of representatives, financial resources requirements, books and records, audit, protection of client assets, and codes for business conduct. The SFC may also attach conditions to a license, including a license to provide ATS. **Procedures for licensing ATS activity under Part V are discussed in Section D of these Guidelines.**
5. In relation to an exemption for ATS activity under clause 118, authorized financial institution means an authorized institution under the Banking Ordinance (e.g. banks). Where an authorized institution is an exempt person under the Bill, it falls within the definition of “intermediary”, and some selective provisions of the Bill will apply to it (e.g. clause 144 relating to client securities and collateral held by intermediaries, and clause 147 concerning the keeping of accounts and records by intermediaries). The SFC may also attach conditions to an exemption to provide ATS. Granting an exemption to an authorized financial institution does not mean that the institution is exempt from regulation. It is only that under the regulatory regime as provided for by the Securities and Futures Bill, the Hong Kong Monetary Authority will be the front-line regulator of the exempt authorized institution. **Procedures**

**for ATS under a Part V exemption are discussed in Section E of these Guidelines.**

### **Part III of the Bill**

6. **Part III provides for SFC authorization of ATS rather than licensing. Under Part III, clause 95 generally prohibits a person from providing ATS unless the person is:**
  - **an intermediary licensed or exempt for ATS activity under Part V; or**
  - **authorized by the SFC to provide ATS under clause 95(2)(a);**
  - **authorized by the SFC to provide ATS under clause 95(2)(b) as a stock exchange or futures exchange outside Hong Kong.**
  
7. Where a person is authorized by the SFC to provide ATS under Part III, the provisions of clauses 95 to 100 will apply. These are relatively brief compared to the more extensive provisions of the Bill that apply to licensed persons. They include procedural matters for application for and withdrawal of authorization. They also enable the SFC to impose conditions to authorization under clause 95(2)(a) and to make rules for the regulation of ATS. A failure to comply with a condition to authorization or a contravention of a rule may constitute an offence. **Section F of these Guidelines provides procedures for authorizing an ATS under clause 95(2)(a), and Section G provides procedures for authorization of an overseas exchange under 95(2)(b).**
  
8. The SFC notes that the definition of ATS excludes facilities provided by a recognized exchange company or a recognized clearing house. Part III provides a separate regulatory regime for recognized exchange companies who operate a stock market or futures market and for recognized clearing houses. In some circumstances, as discussed in Section H of these Guidelines, questions may arise as to whether the provision of ATS may also

constitute operation of a stock market, futures market, or a clearing house.

9. The next two Sections of these Guidelines set out the SFC's principles for the regulation of ATS and its standards of practice for ATS.

## **B. Principles for the regulation of ATS**

10. In general, the provision of ATS should be consistent with or promote: the regulatory objectives of the SFC under clause 4 of the Bill; the functions of the SFC under clause 5 of the Bill; and the matters the SFC shall have regard to under clause 6(2) of the Bill in pursuing its regulatory objectives and performing its functions. In particular, this includes the following principles:
  - the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - understanding by the public of the operation and functioning of the securities and futures industry and of the relative benefits, risks and liabilities of investing in financial products;
  - securing an appropriate degree of protection for members of the public investing in or holding financial products;
  - the reduction of systemic risks in the securities and futures industry;
  - the supervision, monitoring and regulation of activities carried on by persons regulated by the SFC and of such of the activities of exempt persons as are required to be regulated by the SFC;
  - promotion, encouragement and enforcement of proper conduct, competence and integrity of persons carrying on activities regulated by the SFC;

- adoption of appropriate internal controls and risk management systems by persons carrying on activities regulated by the SFC;
- the international character of the securities and futures industry and the desirability of maintaining the status of Hong Kong as a competitive international financial centre;
- the desirability of facilitating innovation in financial products and activities regulated by the SFC; and
- the principle that competition among persons carrying on activities regulated by the SFC should not be impeded unnecessarily.

### **C. Standards of practice for ATS**

11. In addition to the general principles set out above, the SFC has identified core standards of practice for the regulation of ATS. A person providing ATS will generally be expected to meet the following standards to the satisfaction of the SFC.
  - Standard 1: Financial Resources and Risk Management. The financial resources and risk management policies of an ATS provider should comply with appropriate prudential and operational standards.
  - Standard 2: Operational Integrity. An ATS provider should maintain electronic facilities with adequate security, capacity, and contingency arrangements.
  - Standard 3: Fitness. An ATS provider should be a fit and proper person, as established by an authority in Hong Kong or in its home country.
  - Standard 4: Record Keeping. An ATS provider should keep full records of its ATS operations, including audit trails of ATS activity.

- Standard 5: Transparency. 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.
  - Standard 6: Surveillance. 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.
  - Standard 7: Reporting. An ATS provider should keep relevant regulatory authorities informed of its ATS operations and traded products and of material changes to those operations.
12. The SFC intends to take a pragmatic approach to the regulation of ATS in Hong Kong. ATS operations are diverse and likely to grow more so. The regulatory approach will be flexible and applied on a case-by-case basis. 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.
  13. The SFC will consider, among other things, the nature and extent of each ATS activity, the market participants that might be affected by the ATS, whether retail investors may be involved, and whether any systemic risks might arise. Generally, the greater the extent of activity and its potential affect on market participants, and especially if systemic risks might arise, the more that will be expected of the ATS. Where the ATS activity is similar in all the circumstances to that of an exchange company or clearing house, a level playing field will be sought.
  14. The SFC will have regard to international standards and best practices in considering the regulation of ATS. These include



practices recommended by the International Organisation of Securities Commissions, the International Securities Services Association, and the Bank for International Settlements. They also include the practices of regional markets and of other international financial centres. The following paragraphs discuss each of the standards of practice for ATS in greater detail.

*Standard 1: Financial Resources and Risk Management. The financial resources and risk management policies of an ATS provider should comply with appropriate prudential and operational standards.*

15. An ATS licensed or exempt under Part V will normally meet this standard by complying with existing prudential and conduct regulations that apply to licensed dealers and authorized financial institutions. We believe exceptions to this might be appropriate, for example, for an ATS that involves the novation of settlement obligations and provision of settlement guarantees, in which case the SFC will seek to apply international best practices to such activity.
16. An ATS authorized under clause 95(2)(b) as an exchange outside Hong Kong will normally meet this standard by complying with the regulatory regime in its home country. As discussed in Section G, the SFC will consider whether the overseas exchange is subject to home regulation consistent with international best practices.
17. For an ATS authorized under clause 95(2)(a) the SFC will apply this standard on a case-by-case basis. At this time, there are relatively few international examples of financial or prudential regulations for market operators, unlike the well-developed financial regulation of dealers and banks. This is no doubt partly because market operators typically do not act as trading counterparties nor hold clients' securities or funds. In addition, market operators of exchanges are typically subject to relatively extensive regulation even though the regulations typically do not set specific financial resources requirements. In determining the application of this standard, the SFC will follow the analysis mentioned in paragraphs 12 and 13 above.

*Standard 2: Operational Integrity. An ATS provider should maintain electronic facilities with adequate security, capacity, and contingency arrangements.*

18. An ATS licensed or exempt under Part V will normally meet this standard by complying with existing regulatory requirements of the SFC or the HKMA, which will apply to the ATS activity as well. To the extent that the ATS activity poses systemic risk or might affect a significant number of market participants, higher levels of operational integrity may be expected. An overseas exchange authorized under clause 95(2)(b) would be expected to meet international best practices of operational integrity imposed in its home jurisdiction.
19. For an ATS authorized under clause 95(2)(a) the analysis described in paragraphs 12 and 13 will apply. This will normally mean compliance with international best practices applicable to regulated financial institutions. The SFC will also consider the need for independent assessments of the ATS operational integrity as is required in certain circumstances for licensed persons' systems and of recognized exchange companies and clearing houses.

*Standard 3: Fitness. An ATS provider should be a fit and proper person, as established by an authority in Hong Kong or in its home country.*

20. An ATS licensed or exempt under Part V or authorized as an overseas exchange under clause 95(2)(b) typically will have had its fitness and properness established already by competent regulatory authorities. There may, however, be instances where the personnel responsible for ATS were not specifically scrutinised by the relevant regulatory authority. In such circumstances, the SFC will seek to ensure that the ATS-related personnel have qualifications and experience necessary for the reliable operation of the ATS. The SFC will have regard to its Guidance Note on Competence (December 2000).

21. For authorization under clause 95(2)(a) the procedures discussed in Section F will require the ATS provider in its application for authorization to demonstrate to the SFC that it and its key personnel are fit and proper persons to provide ATS. Information will also normally be sought on the substantial shareholders of the ATS provider. Although the process will not be the same as that for obtaining a license under Part V, the SFC will have regard to the standards it already uses in the licensing process and as described in the SFC's Fit and Proper Criteria (December 2000). These include consideration of, among other things, financial integrity, qualifications and experience, reputation, character, and reliability. In addition, the SFC may undertake background checks and liaise with overseas regulators, including those that have entered into information sharing arrangements with the SFC.

*Standard 4: Record Keeping. An ATS provider should keep full records of its ATS operations, including audit trails of ATS activity.*

22. As with the standards discussed above, ATS licensed or exempt under Part V and authorized as overseas exchanges under clause 95(2)(b) will likely comply with much of this standard by virtue of existing codes and regulations. There may be instances where the record keeping requirements for licensed or exempt persons do not focus specifically on important aspects of the ATS operation. This might include, where relevant, details (e.g. time, identities, price, quantity) of order entry or transaction conclusion. In such cases, the SFC will likely require records of these matters to be captured and retained.
23. For ATS authorized under clause 95(2)(a) the SFC will specify on a case-by-case basis the records that must be kept and the retention period to apply. This will vary with the nature of the ATS. The SFC will have regard to the record keeping requirements of licensed persons, exchange companies and clearing houses and seek the level playing field described in paragraphs 12 and 13. For examples, the SFC will most likely require that ATS records be provided to the SFC on request and that the SFC have on-site access to the records of the ATS provider.

*Standard 5: Transparency. 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.*

24. An ATS authorized as an overseas exchange under Part III clause 95(2)(b) is likely to meet this standard by virtue of complying with the requirements in its home country and with the matters described in Section G. There may be special circumstances where additional transparency considerations arise in relation to providing ATS in Hong Kong, but for the typical provision of electronic trading facilities in Hong Kong the transparency provided in the home jurisdiction is likely to be sufficient. The dealers in Hong Kong who provide local investors with access to the overseas exchange will be expected to provide local investors with adequate information about the overseas exchange, including applicable rules, execution and settlement procedures, and prevailing prices.
25. For other ATS licensed or exempt under Part V and authorized under clause 95(2)(a), the SFC/HKMA will expect the ATS provider to make available to its users, information concerning how the ATS operates. Where relevant and among other things, this will likely include information concerning: order processing and execution systems; the rules or other operating requirements; settlement arrangements; fees and charges; and margin requirements and product specifications for derivatives products. This is what is already expected of licensed persons concerning providing information about their operations.
26. In addition to transparency of the ATS operations, the SFC will also consider transparency of trading information. The requirements will depend on the type of ATS involved. In most equity and derivatives trading systems, international best practice is to provide for some level of transparency of bid/ask prices, related quantity, and details of completed transactions. Less transparency typically exists internationally for OTC markets and fixed income markets. This aspect of transparency will be

considered on a case-by-case basis with reference to the type of ATS and relevant international best practices.

*Standard 6: Surveillance. 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.*

27. In this standard, surveillance carries its meaning of careful watch, supervision for the purposes of direction or control, and superintendence. The level of surveillance the SFC will expect of an ATS will vary depending on the nature of the ATS involved. The SFC may also expect the ATS provider to give access to the SFC to enable the SFC to perform surveillance. The SFC will apply the analysis described in paragraphs 12 and 13 to determine the nature and extent of the surveillance functions that will apply to each ATS. Some examples are provided in the following paragraphs.
28. Most ATS providers will have access requirements to determine who may use its ATS. These may take the form of, among other possibilities, financial and credit standards, operational requirements, contractual requirements, or institutional requirements. Depending on the type of ATS involved, the SFC will likely expect the ATS to have access requirements to help to ensure the orderly and legitimate use of the ATS. The SFC will expect these to be transparent and to be monitored and enforced. This is particularly important for an ATS where continued access to the ATS by non-qualified users may adversely affect other market participants, for example a user who acts as a trading counterparty and becomes the subject of a winding up or bankruptcy proceeding.
29. Another surveillance example concerns an ATS that provides trade execution services for products that trade in multiple markets. Situations routinely arise where, for example, trading may be suspended in the primary market pending release of important price-sensitive information. In these circumstances, the

SFC may consider it important for the ATS to also suspend trading in co-ordination with the primary market.

30. The SFC will expect that the main operations of an ATS be monitored continuously to ensure their smooth and reliable operation. The SFC will expect that arrangements are in place to promptly detect and remedy any malfunction in the ATS operations.
31. Depending on the nature of the ATS, there may be situations where unusual activity may create a disorderly or unfair operating environment. For example, an ATS trading derivative products may experience transaction prices that deviate in the extreme from price parameters that would normally be expected in relation to the price of the underlying product. The SFC may expect there to be mechanisms in place to detect such anomalies and investigate the reasons behind them.
32. In considering this standard, the SFC will have regard to its Guidance Notes on Money Laundering (July 1997). Where an ATS performs functions similar to those covered in the Guidelines, the SFC will expect the ATS provider to comply with the Guidelines.
33. For ATS authorized as an overseas exchange under clause 95(2)(b), the SFC will seek its agreement to co-operate with the SFC where the SFC has a need to investigate a situation involving the ATS, as described in Section G. An overseas exchange ATS will also be expected to perform the surveillance functions required of it in its home country. The SFC may in special circumstances seek more, for example a co-ordinated trading suspension in circumstances described in paragraph 29 above.

*Standard 7: Reporting. An ATS provider should keep relevant regulatory authorities informed of its ATS operations and of material changes to those operations.*

34. In some circumstances, an ATS licensed or exempt under Part V will be subject to existing arrangements whereby it must inform regulatory authorities of ATS operations and material changes to

them. Where this is not the case, the SFC is likely to require that the ATS make reports periodically or on request concerning its ATS operations and material changes to those operations. The requirement in each case will be tailored to the nature of the ATS. In some circumstances, the SFC may require the ATS provider to consult with or obtain the prior approval of the SFC before making material system changes. These same considerations will apply to an ATS authorized under clause 95(2)(a). The SFC also expects that it will require at least annual financial statement reports from ATS providers authorized under clause 95(2)(a). The SFC would not normally require any approval of the fees and charges of the ATS provider.

35. For ATS approved as overseas exchanges under clause 95(2)(b), the SFC will normally seek an arrangement for the overseas exchange to make periodic reports to the SFC of the locations where their ATS are provided in Hong Kong. The SFC will also normally seek periodic statistics on the trading activity originating from Hong Kong as discussed further in Section G.

*Additional considerations*

36. As mentioned in paragraphs 12 and 13, the SFC will seek a fair and level playing field for ATS so that similar regulation is applied to similar functions. In this regard, the SFC notes, for example, that clause 381(1) of the Bill enables the Chief Executive in Council to impose a levy, payable to the SFC, on transactions on a recognized stock or futures market or traded by means of ATS. This is a means by which the SFC is funded by market users. Similarly, licensed and exempt persons pay annual fees, which contribute to the SFC's funding. The SFC expects to assess the level of its resources devoted to regulation of ATS and the nature and extent of each ATS. Based on this assessment, it will determine whether principles of fairness, cost recovery, and the "user pays" principle suggests that it should consider annual fees for ATS providers who are not already paying annual fees to the SFC. This assessment will also be used to decide whether to recommend to Government that a levy be recommended to the Chief Executive in Council under clause 381 for ATS. A levy

would not be recommended where transactions are already subject to existing levies.

37. Parts III and XII of the Bill provide for the Investor Compensation Fund and enable the creation of investor compensation arrangements. In March 2001, the SFC published a report on Proposed New Investor Compensation Arrangements. As mentioned in that report, under some circumstances the SFC may seek to include ATS activity within the scope of the investor compensation arrangements. This issue would only be likely to arise where the ATS activity in Hong Kong involved the retail investing public and trading in financial products in Hong Kong not covered by the compensation arrangements existing at the time.

#### **D. Procedures for licensing ATS activity under Part V**

##### *Existing licensed dealers*

38. After enactment of the Securities and Futures Bill, the SFC will assess the activities of existing licensees and determine which of the nine types of regulated activity they will be licensed to carry out under Part V. Considering the definition of ATS and the extensive use of electronic facilities in the securities and futures industry, we believe many licensed dealers will technically fall within the definition of ATS. However, it is not our intention to impose additional, ATS-specific regulations or requirements upon the customary operations of most dealers.
39. For example, consider a person licensed for dealing in securities or futures contracts (i.e. Types 1 and 2 regulated activities) and who is an exchange participant of one of the Hong Kong exchanges. These firms usually provide electronic services to enable clients to trade at the exchanges and may also provide various other services through electronic facilities, such as clearing and settlement or Internet trading. In addition to licensing these corporations for Type 1 or 2 regulated activity, we will also consider licensing them for Type 7 ATS activity.



40. The regulations that would apply here are the normal ones applied to licensed persons. We believe these are sufficient for regulating the electronic ATS-type services provided by most dealers. For example, the various Internet or electronic trading guidance issued by the SFC will apply to Internet or electronic trading services. The SFC Fit and Proper criteria, Code of Conduct, and Internal Control Guidelines will also apply.
41. Under the existing regulations, the SFC will expect, among other things, that ATS-type services will be overseen and operated by competent personnel. Under the Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission, the SFC will expect, among other things, operational integrity. Equally important is the general principle of acting in the best interests of clients. Obtaining a license to provide ATS will not be automatic. The firm must be a fit and proper person to provide ATS.
42. Where a person is licensed for ATS activity, clause 117(1)(c) imposes by law a condition to the license. This provides, in effect, that the SFC may require the person to apply for authorization to provide ATS under Part III. If this is not complied with, the license will be deemed to be revoked. This enables the SFC in special circumstances to require an ATS provider to be authorized under Part III rather than licensed under Part V.
43. Special circumstances. In some special circumstances, the SFC may seek to impose conditions that go beyond or that differ from the normal regulations under Part V for licensees providing ATS. Some of the special circumstances and related conditions were discussed above in Section C of these Guidelines. Finally, as discussed in Section H, the overall activity of the firm may amount to the operation of a stock market, a futures market, or a clearing house.

*New applications to provide ATS under a Part V license*

44. As a general principle, the SFC intends that providers of ATS who also perform traditional dealer functions should apply to be

licensed for all relevant regulatory activities including ATS under Part V. Traditional dealer functions include agency broking, principal trading, market making, corporate finance, investment advice, holding of clients' securities or funds, and securities borrowing and lending. Part V is specifically designed for most of these activities whilst Part III is not. For further information on licensing, a Licensing Information Booklet can be obtained from the SFC.

45. Firms who provide mainly ATS services and do not provide traditional dealer services will normally be considered for authorization to provide ATS under Part III. This is discussed in more detail in Sections F and G.

#### **E. Procedures for ATS under a declaration of exemption from Part V**

##### *Existing exempt persons*

46. Similar to the procedures for existing licensed dealers, under the new Ordinance the SFC will also need to assess the exempt activities of existing exempt dealers. In this regard, clause 118 provides for consultation between the SFC and the HKMA. It also provides for the HKMA to advise the SFC whether the person is a fit and proper person to be granted an exemption. If the HKMA so advises the SFC, the SFC will grant the exemption. The exemption will be subject to such reasonable conditions as the SFC may impose.
47. In many cases, the ATS-type services provided under an exemption from Part V will be similar to those of existing licensed dealers described above. In other words, the securities business is today highly automated and exempt dealers may therefore fall within the definition of providing ATS. In these cases, we would expect the exemption to continue as normal and apply to ATS activity. In special circumstances, discussed in Section C concerning standards of practice for ATS, the SFC may consider additional requirements for an exemption to provide ATS. As discussed in Section H, it is possible that the overall activity of the firm may amount to the operation of a stock market, a futures market, or a clearing house.

*New applications to provide ATS under an exemption from Part V*

48. Authorized financial institutions who intend to enter the business of providing traditional dealer functions and ancillary ATS, should apply for an exemption under Part V. The process will generally follow that of existing exempt persons described above.
49. Some authorized financial institutions who are not existing exempt dealers may perform services that had previously not required an exemption, but may arguably fall within the new ATS regulated activity. For example, many authorized financial institutions provide a range of securities processing services such as money payment for securities transactions, custody, and nominee services. The SFC believes that most of these services as traditionally provided do not constitute ATS. But the overall activity of a firm or the introduction of non-traditional services has the potential to fall within the ATS definition. Firms who have any questions concerning their operations should seek clarification from the HKMA or the SFC.
50. Other authorized financial institutions may wish to introduce new services that do clearly constitute ATS. An example is an authorized financial institution who intends to provide to investors or other market participants an electronic trading system for securities or futures contracts.
51. In these circumstances, it is possible for an exemption to be granted under Part V or authorization to be given under Part III. The decision as to which process to follow will be made on a case-by-case basis and in consultation with the HKMA. Section H concerns whether the activity might amount to operating a stock or futures market.
52. These Guidelines do not cover the many other procedural and substantive aspects of granting or refusing to grant licenses or exemptions under Part V nor the review of the SFC's decisions. Interested persons may refer to Part V and the SFC's Licensing Information Booklet for further information.

## **F. Procedures for authorizing an ATS under Part III, clause 95(2)(a)**

53. As mentioned, there are two main provisions under Part III, clause 95 for the authorization of an ATS. The first is a general provision for authorization under clause 95(2)(a), which is discussed here. The second one is specific to a stock or futures exchange outside Hong Kong under clause 95(2)(b), which is discussed in Section G.
54. As explained in paragraph 44, persons who provide ATS and traditional dealer functions should seek a Part V license for their activities, including ATS. Persons who provide ATS, but do not also engage in traditional dealer activities, should seek authorization under Part III. This section sets out the application procedures for authorization under clause 95(2)(a).

### *Application procedures for authorization under clause 95(2)(a)*

55. An application under clause 95(2)(a) should be accompanied by the information specified below. An application fee may be prescribed by rules made under clause 382. The SFC also encourages potential applicants to contact the SFC to arrange a meeting to discuss the application process with SFC staff.
- Name, address(es) and contact details of the corporation(s) to provide ATS.
  - Names and biographies of corporate directors and key employees. The qualifications and experience of key personnel should be included.
  - Information about any substantial shareholders and where a substantial shareholder is a corporation, the directors and substantial shareholders of that corporation.
  - Financial statements or other financial information for the corporation(s) mentioned above.

- Description of the services and facilities the corporation(s) intends to provide under the ATS authorization and of any other businesses it carries on or intends to carry on.
  - Description of the hardware, software and other technology, including back up arrangements and testing plans, to be used in providing ATS.
  - Description of the intended users of the ATS, how users will be approved or disapproved, suspended and copies of related contractual documentation.
  - Copies of rules, procedures, and any other documentation governing use of the ATS.
  - Description of the fees and charges for using the ATS.
  - Description of why the ATS is consistent with or will promote the principles set out in Section B and how the ATS will comply with the standards of practice set out in Section C of these Guidelines.
56. In considering an application for authorization under clause 95(2)(a), the applicant is likely to be asked to submit further information and particulars as the SFC may reasonably require under clause 96. The SFC may also have regard to any information in its possession whether provided by the applicant or not, under clause 96(3).
57. If the SFC decides to authorize an applicant to provide ATS it will notify the applicant in writing. The authorization will be subject to such conditions the SFC considers appropriate and these will be specified in the notice. Any conditions being considered by the SFC will in most circumstances be discussed first with the applicant. Under clause 97, the SFC may, by notice in writing to a person authorized to provide ATS under clause 95(2)(a), amend or revoke any conditions or impose new conditions where it is satisfied that it is appropriate to do so. The SFC will cause notice of the authorization to be published in the Gazette. The SFC will

normally give a deficient ATS provider a reasonable period to improve their operations.

58. If the SFC is minded not to grant the authorization, it will give the applicant a reasonable opportunity of being heard before making a decision not to grant the authorization. Certain decisions of the SFC concerning authorization as an ATS may be appealed to the Securities and Futures Appeals Tribunal (SFAT) under Division 2, Part XI of the Bill. Schedule 7, Part 2 of the Bill provides that the following relevant decisions may be appealed to the SFAT:

Clause 95(2)(a) or (b)	Refusal to grant an authorization.
Clause 97(1)	Amendment or revocation of any condition, or imposition of any new condition.
Clause 98(1)	Withdrawal of an authorization.

59. Under clause 98, the SFC may withdraw an authorization granted under clause 95(2), where it is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest. Notice of this would be published in the Gazette. The SFC would give the person a reasonable opportunity of being heard before exercising this authority.

**G. Procedures for authorizing an ATS under Part III, clause 95(2)(b) as a stock exchange or futures exchange outside Hong Kong**

60. Clause 95(2)(b) enables the SFC to authorize a stock exchange or futures exchange outside Hong Kong to provide automated trading services in Hong Kong. From our experience, we expect the typical provision of ATS by an overseas exchange to involve the placement of their dedicated trading terminals in Hong Kong or the provision of technical specifications and support services to enable Hong Kong institutions to make computer-to-computer connections to the overseas exchange's systems.
61. In this regard, overseas exchanges have always been accessible to Hong Kong investors, either through Hong Kong financial intermediaries or overseas intermediaries. Whilst historically trading by Hong Kong persons may have been effected through

the telephones, fax, or telex it is today often done through computer linkages, the Internet, and Extranets.

62. As mentioned above, the SFC believes that authorization of an overseas exchange under clause 95(2)(b) should be based on an assessment by the SFC that the overseas exchange should be subject to regulation in its home country comparable to the regulation of exchanges in Hong Kong and consistent with international standards. Through its own regulatory benchmarking and participation in international regulatory forums such as the International Organisation of Securities Commissions, the SFC will often be in a position to make this assessment without requesting detailed information from the overseas exchange. If not, the SFC will need to request information from the overseas exchange to assist it in making this assessment.
63. In general, an overseas exchange seeking authorization under clause 95(2)(b) should contact the SFC to arrange a discussion with SFC staff. We will typically request a summary information package about the exchange's most recent operations and a full description of the ATS to be provided in Hong Kong.
64. The SFC will normally expect the overseas exchange to undertake to :
  - provide information regarding the products to be traded through the ATS in Hong Kong;
  - provide periodic statistics of the nature and volume of such trading in Hong Kong;
  - provide copies of any documentation which users of the ATS in Hong Kong will enter into concerning the ATS;
  - provide information on any later changes to the ATS provided in Hong Kong;
  - provide information concerning the identity and location of persons using the ATS in Hong Kong;

- limit use of the ATS in Hong Kong to persons licensed with the SFC or exempt from licensing under Part V of the Bill, unless the SFC agrees otherwise;
  - satisfy the SFC that appropriate levels of information disclosure and co-operation will be made available to the SFC concerning any specific requests or investigations in relation to the ATS in Hong Kong, including information about particular transactions, ATS users, and ATS users' clients.
65. The SFC will normally wish to see that a Memorandum of Understanding or other information sharing and co-operation arrangement has been entered into between the SFC and the home regulator of the overseas exchange. The SFC will also take into consideration whether the home country of the overseas exchange allows Hong Kong persons to access its markets through ATS facilities and if so the terms on which such access is allowed.
66. The general principle that the SFC will adhere to is to prevent regulatory arbitrage and to avoid the fragmentation of the local markets. If the overseas exchanges are in direct competition with the Hong Kong exchanges and may cause fragmentation of the local markets, or their activities may have a significant impact on the local markets, the SFC may take action or impose conditions on the overseas exchange in order to resolve the situation.
67. In some special circumstances, additional issues may arise with ATS of overseas exchanges. For example, if similar or fungible products are traded on the overseas exchange and on a Hong Kong exchange. These and other special circumstances will be addressed on a case-by-case basis and with a view to achieving a fair and level playing field in all the circumstances.
68. If the SFC authorizes an overseas exchange to provide ATS it will cause notice of this to be published in the Gazette. If the SFC is minded not to grant authorization it will first give the overseas exchange a reasonable opportunity of being heard. Authorization may be withdrawn under clause 98, but a reasonable opportunity of being heard would be afforded. The SFC's decisions to



authorize or withdraw authorization can be appealed to the SFAT under Division 2, Part XI of the Bill.

## **H. Operation of a stock market, futures market, or a clearing house**

69. Schedule 1 of the Bill defines “stock market”, “futures market”, and “clearing house”. As mentioned above, there are various implications to falling within these definitions.
70. In the case of “stock market”, clause 19(1)(a) prohibits a person from operating a stock market unless the person is (i) the Stock Exchange Company, (ii) a recognized exchange company of which a relevant recognized exchange controller is the controller, or (iii) a relevant recognized exchange controller which is itself a recognized exchange company. Clause 18(1) defines “relevant recognized exchange controller” as a recognized exchange controller, which is the controller of the Stock Exchange Company. In the current circumstances, this effectively limits the persons who may be recognized to operate a stock market to Hong Kong Exchanges and Clearing Ltd and its affiliates. Note also that the definition of stock market does not include the office of (a) an exchange participant of a recognized exchange company or (b) a recognized clearing house.
71. In the case of “futures market”, clause 19(1)(b) prohibits a person from operating a futures market unless the person is a recognized exchange company. Clause 19(2) enables the SFC to recognize a company as an exchange company, where it is satisfied of the matters mentioned in clause 19(2)(a) and (b) and after consultation with the public and the Financial Secretary. The SFC may also attach conditions to recognition as an exchange company. Clause 19(8) provides that a person licensed or exempt for ATS activity or authorized for ATS under clause 95(2) will not be regarded as contravening clause 19(1)(b) if the person is permitted to engage in the activities that constitute operating a futures market. Division 2 of Part III of the Bill provides the overall regulatory regime for recognized exchange companies.
72. Clause 37 of the Bill enables the SFC to recognize a company as a clearing house where it is satisfied of the matters mentioned in

clause 37(1)(a) and (b) and after consultation with the Financial Secretary. There is no prohibition provision similar to clause 19(1) against operating a clearing house without recognition. The SFC may also attach conditions to recognition as a clearing house. Division 3 of Part III of the Bill provides the overall regulatory regime for recognized clearing houses and includes special provisions relating to the law of insolvency.

## **I. Examples of the likely application of the ATS Guidelines in practice**

73. This section provides hypothetical ATS operations and the likely application to them of the ATS Guidelines. It is without prejudice to the SFC's actual decisions to be made in any future case.

*Example 1. A person is licensed or exempt for Type 1 activity of dealing in securities and Type 7 activity providing ATS. The person provides comprehensive Internet trading and related services.*

74. As explained in Section D it is not the SFC's intention to impose additional ATS-specific regulations or requirements on the customary operations of most dealers, including Internet dealing. The regulations that would apply are the normal ones applied to licensed or exempt persons. For examples, these include the SFC's Guidance on Internet and Electronic Trading, the Code of Conduct, and the SFC's Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission.

*Example 2. An overseas person provides ATS services from an overseas location either as a dealer or as a market or an exchange, including via the Internet.*

75. The provisions of the Bill concerning ATS do not have extraterritorial effect. Unless the person can be viewed as providing ATS in Hong Kong, the person need not obtain a license or be authorized for ATS activity with the SFC. However, if the person targets its ATS activity at people residing in Hong Kong, the SFC may take the view that a license or authorization is

required. See the SFC's Guidance Note on Internet Regulation, (March 1999).

*Example 3. An overseas exchange provides for the placement of its trading terminals in Hong Kong or offers direct, remote access rights to intermediaries or investors in Hong Kong via electronic facilities.*

76. The SFC takes the view that the overseas exchange should apply for authorization under Part III, clause 95(2)(b), as explained in Section G.

*Example 4. A person provides over the Internet or other electronic facilities a "bulletin board" service over which persons post indications of interest to buy or sell securities or futures contracts. The person does not provide services to conclude or settle transactions.*

77. This would appear to be within the definition of providing ATS. However, most of the regulations to apply to ATS described in Section C of these Guidelines are designed to address ATS, for example, that provide services involving the interaction of multiple buyers and sellers and that execute or match transactions on a non-discretionary basis. They are not aimed at a simple bulletin board ATS. In the case of a simple bulletin board ATS, the SFC would likely impose very little in the way of regulation, but would impose a condition that the bulletin board ATS not expand its operation without consulting with the SFC.

*Example 5. A person provides telecommunications services or is an internet service provider and these electronic facilities are used by other persons to provide ATS.*

78. The SFC would not normally take the view that the person providing telecommunications or Internet services was providing ATS.

*Example 6. An authorized institution or trust company provides securities custody services, including transaction settlement related services.*

79. As explained in Section E, the SFC would not normally take the view that the person is providing ATS.

*Example 7. A person provides electronic facilities whereby offers to buy or sell foreign currencies or goods or services are made, transactions are concluded, and settlement is effected.*

80. The ATS definition applies to securities or futures contracts. Electronic facilities for trading in spot foreign currencies or goods and services that do not constitute securities or futures contracts are not caught by the ATS definition.

*Example 8. A person provides electronic facilities whereby offers are regularly made to buy or sell fixed income instruments, transactions are concluded, and settlement is effected.*

81. If the fixed income instruments constitute securities, the SFC would view this as providing ATS. If the ATS provider did not perform traditional dealing functions as described in Section D, the ATS would be considered for authorization under Part III, clause 95(2)(a). The level of regulation to apply would follow the principles and standards as described in Sections B and C. Questions might arise as to whether the activity also amounts to the operation of a stock market as discussed in Section H. In those circumstances, the SFC would likely ask the ATS provider to submit a legal analysis to the SFC indicating why the activities do not constitute as the operation of a stock market.

*Example 9. An exchange participant licensed for Types 1 and 7 activity provides ATS for investment products. Transactions are not effected through or reported to the Stock Exchange or Futures Exchange. The investment products are provided to the retail investing public.*

82. Although the exchange participant is licensed under Part V, the provision of an electronic trading service to the investing public would need to be analysed under the standards described in Section C, in particular paragraphs 12 and 13. A level playing

field in all the circumstances and in terms of investor protection and regulation would be sought.

**J. Consultation period**

83. The SFC invites comments from the public on this draft Consultation Paper. Comments should be received by the SFC by Friday 4 May 2001 and should be addressed to:

Securities and Futures Commission  
12<sup>th</sup> Floor, Edinburgh Tower  
The Landmark  
15 Queen's Road Central  
Hong Kong

Comments may also be faxed to (852) 2521 7917 or sent by email to [ATSconsult@hksfc.org.hk](mailto:ATSconsult@hksfc.org.hk). This Paper is also available on the SFC website at <http://www.hksfc.org.hk>.