



Hong Kong Law

March 2014

SFC CONSULTS ON THE REGULATION OF ALTERNATIVE LIQUIDITY POOLS

The Securities and Futures Commission (**SFC**) is consulting the public on amending the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) to regulate operators of alternative liquidity pools (**ALPs**). A new Paragraph 19 and a new Schedule 8, available as appendices A and B respectively in the SFC's Consultation Paper, are proposed to be added to the Code of Conduct. Responses to the consultation may be submitted before 25 April.

Background of ALPs

ALPs, also known as "dark pools", are trades that result from the matching of buy and sell orders outside of "lit" markets. These trades are executed anonymously and their particulars are not revealed to the public until they have been filed. They therefore lack pre-trade transparency, resulting in information asymmetry between the typically large institutional investors who engage in them and all other parties.

Although ALPs are beneficial in that they provide lower costs of trading for investors who engage in high-volume trades by mitigating the impact of such trades, there has been concern that they are detrimental to the price discovery function provided by traditional exchanges, as the impact of such trades upon the prices of securities are not apparent until the trade is complete. ALPs may not be beneficial to retail investors who engage in trades in relatively small volumes.

Current regulation of ALPs

Since 2003, operators of ALPs have been required by the Securities and Futures Ordinance (**SFO**) to be licensed to provide automated trading services (**ATS**). Since they deal in securities and provide ATS, these operators must be licensed to engage in both Type 1 and Type 7 activities. Currently, the Stock Exchange of Hong Kong (the **Exchange**) requires participants to report and flag all trades conducted on ALPs within one minute after the trade is executed. The SFC regulates ALPs by imposing the following conditions on the licences of ALP operators:

- allowing only institutional investors to access ALPs;
- requiring ALP operators to provide those who use their ALPs with information on how their systems operate;
- conditions concerning conflicts of interest from agency and proprietary orders;
- conditions concerning the visibility of trade information available to the staff of ALP operators;
- conditions concerning internal controls; and
- conditions concerning record keeping and reporting.

Proposed additions to the Code of Conduct

The SFC proposes to regulate the operation of ALPs by including a set of requirements in the Code of Conduct that are similar to the conditions currently imposed upon the licences of ALP operators. Additionally, the SFC proposes certain obligations to be imposed upon other licensed or registered persons who trade in third party ALPs either for themselves or on behalf of their clients. All of these requirements are proposed to be added to the Code of Conduct as a new Paragraph 19 and Schedule 8, as detailed below.

Management and supervision (Paragraph 19.3 and paragraphs 3 to 6 of Schedule 8)

ALP operators would be required to manage and supervise effectively the design, development and operation of the ALPs they operate. This includes implementing written internal policies and procedures to ensure that:

- at least one responsible officer or executive officer is responsible for the overall management and supervision of the ALP;
- there is a formalised governance process involving the ALP operator's risk and compliance functions;
- there are clear reporting lines with supervisory and reporting responsibilities assigned to appropriate staff members; and
- there are managerial and supervisory controls designed to manage effectively risks associated with ALPs.

ALP operators would also be required to assign adequately qualified staff, expertise, technology and financial resources to design, develop, deploy and operate the ALP.

Access to ALPs (Paragraph 19.4 and paragraphs 7 and 8 of Schedule 8)

Since trades may be executed in ALPs at any time, including outside of Exchange trading hours, it is impossible for retail investors to ascertain their expected reduction in trading costs by using an ALP. Therefore, the main benefit to using ALPs, reduction to the costs of trading (particularly in large volumes), is not practical for retail investors to realise. Given that retail participation in the stock market in Hong Kong is relatively high, the SFC proposes to limit access to ALPs to institutional investors (as defined in Paragraph 19.2 of the Code of Conduct).

However, it is noted in the Consultation Paper that access to ALPs may become available to retail investors in the future if adequate regulations can be established to protect them.

With regard to institutional investors who act on behalf of retail clients, the SFC proposes to require ALP operators to ensure that their clients and the clients of their group companies do not conduct transactions in an ALP unless that client is an institutional investor. This requirement is proposed to avoid ALP operators from exploiting a loophole by positioning a group company between itself and a retail client who places a trade order. An ALP operator would be free from this requirement if the intermediary is not a group company, but would still be expected to act reasonably and take reasonable steps to prevent retail investors from trading in its ALP. Paragraph 19.4(b) of the Code of Conduct would additionally require that persons licensed or registered under the SFO may only route or relay orders to ALPs if they originated from institutional investors.

Operation of ALPs (Paragraph 19.5)

While ALP operators who acquired their licences from the SFC in the past do not face restrictions in the transactions they execute or their times of operation, those who have been licensed more recently are required by conditions imposed upon their licences to execute only trades that involve securities that are listed on the Exchange and only during the Exchange's trading hours. To address this inconsistency, and in view of the regulation of ALPs in other jurisdictions, the SFC proposes to allow all ALP operators to execute trades of securities that are or are not listed or traded on the Exchange at any time, whether during or outside of the Exchange's trading hours.

Order priority (Paragraph 19.6)

To avoid conflicts of interest it is proposed that ALP operators be required to ensure that the orders of users of their ALPs have priority over **Proprietary Orders**, which are defined as orders for:

- the account of the ALP operator trading as principal;
- the account of any user of the ALP, which is a company within the same group of companies as the ALP operator, trading as principal;
- any account in which the ALP operator, or any user of the ALP that is a company within the same group of companies as the ALP operator, has an interest; or

- the account of any employee or agent of the ALP operator or of any user of the ALP which is a company within the same group of companies as the ALP operator

unless those orders are Proprietary Orders themselves.

The SFC proposes that, where an ALP operator receives a non-Proprietary Order and a Proprietary Order for the same securities, the non-Proprietary Order should have priority whenever the two orders are being executed in the ALP at the same price, regardless of when the orders were received.

Information for users (Paragraph 19.7 and paragraphs 9 to 12 of Schedule 8)

It is proposed that ALP operators be required to prepare and publish comprehensive and accurate guidelines in relation to their provision of ALP services (**ALP Guidelines**) on their website. These guidelines must inform users of their ALPs as to:

- trading and operational matters;
- user restrictions;
- user priority, order routing and execution methodology;
- transaction pricing;
- order cancellation;
- the internal control procedures in place to ensure fair and orderly functioning of the ALP and to address potential conflicts of interest;
- any potential risks associated with transactions executed in its ALP of which users should be aware;
- the transaction of proprietary orders in the ALP;
- whether orders of different users of the ALP may be aggregated; and
- the identity of each staff member of the ALP operator (including title and department) who is allowed to access trading information of the orders placed and executed in the ALP, and why such access is permitted.

ALP Guidelines should be comprehensive, accurate, current and must be published and revised or updated on the ALP operator's website and circulated to users of its ALPs as soon as reasonably practicable. ALP operators would be required to provide their ALP Guidelines (and any subsequent revisions of them) to the SFC upon their publication on their own websites. ALP operators would also be required to inform every prospective ALP user of their ALP Guidelines and obtain from them acknowledgements that they have been so informed and consent to the their orders being executed in the ALP. If that acknowledgement is not obtained from a prospective ALP user, then the ALP operator must not allow orders from that user to be executed in its ALP. Intermediaries which route trade orders to ALPs operated by third parties would be required to ensure that their clients give the same acknowledgement before their orders may be routed.

Adequacy of trading systems (Paragraph 19.8 and paragraphs 13 to 20 of Schedule 8)

ALP operators would be required to have control measures in place so that it is possible to prevent certain transactions from being conducted in their ALPs. They would also have to ensure that their ALPs (and any modifications to them) are adequately tested before deployment and regularly reviewed for reliability. Any significant issues involving ALPs, including interruptions of service, should be reported to the SFC promptly. ALPs must have adequate security controls that should include, at a minimum:

- reliable techniques to ensure that an ALP is only accessible to persons whose access to it is essential and approved by the ALP operator;
- effective techniques to protect the confidentiality and integrity of information concerning ALP transactions passed between internal and external networks;
- operating controls to prevent and detect unauthorised intrusion, security breach or attack; and
- measures to raise the awareness of an ALP operator's staff as to the importance of security and the observance of security in relation to its ALP.

ALP operators should ensure that all security requirements are met, even if an ALP is developed by a third party vendor.

In relation to system capacity, ALP operators should ensure that:

- the usage capacity of their ALPs is regularly monitored;
 - capacity planning is conducted (keeping in mind the required level of spare capacity);
 - regular stress tests are done under different simulated market conditions;
 - the results of stress tests are documented;
 - there is sufficient capacity for any foreseeable increase in business volume and market turnover; and
 - there are alternative means of executing orders available for users of their ALPs in situations of exceeded system capacity, which must be communicated to the users.
- the basis upon which it is necessary to access ALP trading information in each case; and
 - any changes made as to which staff members can access ALP trading information and the basis for the change.

ALP operators should have written contingency plans for disruptions to ALP operations, including, at a minimum:

- a backup facility to allow the ALP to continue to operate in an emergency;
- arrangements to back up user and transaction databases and servers in an offline medium, with off-site storage that includes proper security measures; and
- trained staff available to handle user and regulatory enquiries.

Only staff members of ALP operators would be allowed to access trading information concerning orders and trades on their ALPs, and only to the extent necessary to allow the ALP to operate. ALP operators would be required to maintain access logs to record which staff members have had access to their ALPs, the information accessed, the time of access and any approval that was given for the access. There must be effective systems and controls to prevent and detect ALP trading information leakage or abuse by staff members, as well as measures to ensure that any person responsible for originating an ALP trade instruction cannot access any ALP trading information or transaction data other than confirmation of the outcome of that order. ALP operators must keep the SFC informed at all times as to:

- which of their staff members (by title and department) have access to ALP trading information and what information they can access;

Record keeping (Paragraph 19.9 and paragraphs 21 to 23 of Schedule 8)

ALP operators would be required to keep comprehensive documentation of the design, development, deployment and operation of their ALPs, including all tests, reviews, modifications, upgrades or rectifications of ALPs and the risk management controls of ALPs. This documentation must be retained for not less than two years after an ALP ceases to operate.

Moreover, ALP operators must maintain records of all the ALP transactions they have executed and details of any authorised traders. The following table summarises how such records should be kept:

Type of record	Records of ALP transactions	Time-sequenced records of ALP orders and any other ALP actions and activities
Time period to keep the records	Not less than 7 years	Not less than 2 years
Language of the records	Written Chinese or English (or easily convertible to such)	
Access to the records	Readily accessible to provide to the SFC upon request	

<p>Particulars of the records</p>	<ul style="list-style-type: none"> • details of the users of the ALP (registered names and addresses, dates of admission and cessation, authorised traders and related details and client agreements) • details of any restriction, suspension or termination of access of any ALP user including the reasons for it; • all notices and other information (written or electronic) from the ALP operator to the ALP users (individually or generally); and • routine daily and monthly summaries of ALP trading, including the securities involved in the executed transactions and the transaction volumes (number of trades), numbers of securities traded and the total settlement value. 	<ul style="list-style-type: none"> • the date and time that any order was received, executed, modified, cancelled or expired (where applicable); • the identity, address and contact details of the ALP user and the authorised trader who initiated any entry, modification, cancellation or execution of an order; • the particulars of any order and subsequent modification and execution of the order (the securities involved, the size and side (buy/sell) of the order, the order type, any order designation, time and price limit or other conditions specified by the user who originated the order, etc.); and • the particulars of the allocation and any re-allocation of an execution of an order.
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Risk management (Paragraph 19.10 and paragraphs 24 to 27 of Schedule 8)

ALP operators must have effective controls in place to monitor and prevent crossing orders in in their ALPs that may be erroneous, interfere with the operation of a fair and orderly market, or breach any laws or regulations. Regular post-trade reviews of transactions should be conducted in ALPs to identify:

- suspicious market manipulative or abusive activities;
- market events or system deficiencies that call for further risk control measures; and
- actual and potential breaches of any requirements in relation to fair and orderly trading in an ALP or which might constitute market misconduct.

If an ALP operator becomes aware of any actual or potential breach of any laws or regulations, or any of the anomalies listed above, it would be required to inform the SFC of the matter and provide any assistance it requests. In the case of market manipulative or abusive trading activities, the SFC proposes to require ALP operators to take immediate steps to prevent their continuation.



Reporting and notifications (Paragraph 19.11 and paragraphs 28 and 29 of Schedule 8)

ALP operators would be required by the SFC to:

- report all ALP transactions to the Exchange and any other exchange or regulator outside Hong Kong in accordance with the rules and regulations of the Exchange or non-Hong Kong exchange or regulator, as the case may be;
- make regular transaction analyses available to ALP users concerning transactions executed in their ALPs; and
- provide the SFC with a report recording the volume of trades conducted by each of the ten largest of its ALP users for each calendar month, within ten business days after the end of each calendar month or on the SFC's request.

An ALP operator must provide the SFC with prior notification and explanation if the operation of its ALP or the users of its ALP might be affected by proposed changes in any of the following:

- corporate structure and governance arrangements;
- business plans or operations;
- the trading rules, trading sessions or operating hours;
- the system operator, hardware, software or other technology of its ALP;
- any system interface between its ALP and other ALPs or electronic trading platforms;
- the ALP operator's contractual responsibilities to its ALP users;
- the criteria for approval or disapproval of its ALP users; and
- the contingency plan of its ALP.

ALP operators must also notify the SFC immediately of:

- any breach of relevant regulations or ALP Guidelines;

- actual or possible causes of material delay or failure to the operation of their ALPs that affect their ALP users; and
- any updated review report concerning its ALP, upon availability.

Consultation Questions

The SFC poses the following questions in the Consultation Paper:

Q1	Do you agree that the proposed requirements are sufficient to ensure that an ALP operator effectively manages and adequately supervises the design, development, deployment and operation of the ALP it operates? If not, why not?
Q2	Do you agree that only the orders of institutional investors should be permitted to be transacted in ALPs? If not, why not?
Q3	Do you think that the definition of “institutional investor” set out in the draft paragraph 19.2 of the Code of Conduct is appropriate? If not, why not?
Q4	Do you agree that ALP operators should be obliged to ensure that all orders placed with them by their group companies originate from institutional investors before they may be transacted in their ALPs? If not, why not?
Q5	Do you agree that a licensed or registered person who routes orders to an ALP on behalf of its clients should be obliged to ensure that such orders originate from institutional investors only? If not, why not?
Q6	Do you agree that ALP operators should be allowed to conduct transactions in their ALPs in all types of exchange listed or traded securities, irrespective of whether they are listed or traded in Hong Kong or elsewhere? If not, why not?
Q7	Do you agree that ALP operators should be allowed to conduct transactions in their ALPs in securities listed or traded on overseas markets / exchanges without restriction as to the time when they may do so? If not, why not?
Q8	In respect of transactions conducted in ALPs involving securities which are listed on SEHK, do you agree that ALP operators should be allowed to conduct these transactions in their ALPs during the periods that trading is conducted on SEHK and also at other times when trading is not being conducted on SEHK? If not, why not?
Q9	Do you agree that orders received from the users of ALPs should have priority over proprietary orders of the types referred to in paragraph 34? If not, why not?
Q10	Do you agree that ALP operators should be obliged to provide prospective users of their ALPs with ALP Guidelines that are comprehensive and accurate and that their ALP Guidelines must include the matters referred to in paragraph 38? If not, why not?
Q11	Do you agree that ALP operators should bring their ALP Guidelines to the attention of all prospective users of their ALPs? If not, why not?
Q12	Do you agree that an ALP operator should be obliged to obtain formal acknowledgement from prospective users of its ALP that its ALP Guidelines have been brought to their attention and that they consent to their orders being transacted in the ALP, before such transactions are permitted to occur? If not, why not?
Q13	Do you agree that a licensed or registered person which, on behalf of its clients, routes agency orders to an ALP operated by a third party ALP operator should be obliged to ensure that its clients have formally acknowledged that the ALP Guidelines have been brought to their attention and that they consent to their orders being transacted in the ALP, before their orders are routed to the ALP? If not, why not?
Q14	Do you agree that an ALP operator should adopt measures to ensure the integrity and/or system adequacy of its ALP and have appropriate contingency measures in place? If so, are the proposed requirements sufficient? If not, why not?
Q15	Do you agree that an ALP operator should keep the SFC informed as to the identity of its staff having access to trading and other information relevant to its ALP, the basis upon which such access is permitted, and any change made in relation to the staff to whom such access is permitted and the basis for such change? If not, why not?

Q16	Do you agree that the person responsible for originating a proprietary order in an ALP should be restricted from access to trading information or data concerning orders placed, or transactions conducted, in the ALP? If not, why not?
Q17	Do you agree that an ALP operator should keep proper records concerning the design, development, deployment and operation of its ALP? If not, why not?
Q18	Do you agree that an ALP operator should keep proper records concerning all transactions conducted on its ALP, including details of authorized traders? If not, why not?
Q19	Are the records that the SFC proposes be kept by ALP operators in relation to the transactions conducted in their ALPs sufficient and appropriate? If not, why not?
Q20	Do you agree with the proposed periods for the keeping of these records? If not, why not?
Q21	Do you agree that the proposed requirements for risk management and post-trade reviews of transactions conducted in ALPs are sufficient to maintain the fair and orderly operation of the market? If not, why not?
Q22	Are the proposed reporting and notification requirements appropriate? If not, why not?

Submission of Comments

Written comments may be submitted to the SFC no later than 25 April 2014 in the following ways:

By mail to:	Securities and Futures Commission 35/F, Cheung Kong Center 2 Queen's Road Central Hong Kong Re: Consultation Paper Concerning the Regulation of Alternative Liquidity Pools
By fax to:	(852) 2501 0375
By online submission to:	http://www.sfc.hk
By e-mail to:	alpconsultation@sfc.hk

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