



## CONSULTATION PAPER CONCERNING THE REGULATION OF ALTERNATIVE LIQUIDITY POOLS

### The Law Society's Submissions

Thank you for the opportunity to respond to the consultation paper on Alternative Liquidity Pools (ALPs).

We have set out below some general thoughts on the consultation exercise, followed by specific answers to the questions raised.

#### GENERAL OVERVIEW OF OUR RESPONSE

We have no quarrel with the SFC's wish to regularize and codify the current inconsistencies in treatment of automated trading services operators rather than the position depending upon when the licence was granted and which conditions were attached to the licence. That seems a reasonable approach so as to ensure a level playing field for all participants.

However, it is important to appreciate that ALPs are a small piece in the overall electronic trading picture in Hong Kong at the present time, and while it makes sense to front-load regulatory responses to perceived challenges and issues, these proposals appear to be somewhat unbalanced in their overall context in the market as regards size, importance and the nature of the intended participants. The tougher proposals can be "switched on" as appropriate as and when the Hong Kong market evolves to a point where they become relevant.

We are puzzled by the need for many of the proposed regulatory changes, given at this stage the status of the Hong Kong market in relation to ALPs. If the major "mischief" of operating ALPs in the HK market is the negative impact on trade information transparency (whether for the price discovery process or for market monitoring or surveillance by regulators), then the regulations ought to focus on increasing trade information disclosure for those purposes whilst balancing the practicality of compliance and onus on ALP operators.

There is a clear intention on the face of the consultation paper to exclude retail investors

from being able to access ALP, and accordingly to restrict such access to institutional investors, both directly and indirectly. At this stage of the development of the Hong Kong markets, there is a Hong Kong Stock Exchange monopoly which is highly unlikely to be removed or diluted. We consider it not to be a worthwhile line of argument to explore any such removal or dilution.

We can accordingly see the need for the restricted access provisions, since no retail investors will be allowed to participate in any way.

As a result, since only institutional investors will be able to access ALPs, and given the low level of relevant market turnover (2 per cent. as quoted in the consultation paper) and the small number of licensed corporations (16 at the end of December 2013), it seems odd to build into the proposed regime a significant layer of compliance requirements, particularly the onerous information for users and record keeping requirements which appear to us to be highly inappropriate for a professionals-only environment.

We of course recognize the need for operators of ALPs to ensure that the systems are adequate and properly supervised, as a general matter of good practice, but would expect this to be handled at a guidance level in the context of licensed corporations carrying on business in a regulated activity, rather than there being a need at this point for heavy regulation.

If retail investors were to be allowed onto an ALP, that would of course change the position dramatically, and as and when that development occurred, that would be the time to consider protections for that segment of users.

While we note that a number of the proposals are essentially a matter of turning into formal regulation what is already often set out in licence conditions, we do not regard that as a bar to making comments on this issue in respect of the formalization of the regime. It seems appropriate to consider the need for such conditions, and their translation into full regulatory obligations, at a time of introducing the ALP regime.

There seems to be an inconsistency of approach: the proposed package of measures appears to have been designed for robust protection of users unable to protect themselves adequately, but ALPs are to be restricted to use only by persons who should in fact be fully equipped to look after their own interests.

## **ANSWER TO SPECIFIC QUESTIONS**

*Question 1: 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?*

### **Law Society's response:**

Since the proposals broadly reflect the position under the recently introduced electronic trading regime, yes.

*Question 2: Do you agree that only the orders of institutional investors should be*

*permitted to be transacted in ALPs? If not, why not?*

**Law Society's response:**

As indicated in our overview, we would not expect retail investors to be entertained at this stage of the Hong Kong market's life cycle, given the Hong Kong Stock Exchange monopoly, so have no comment on this.

*As a general note in relation to restricting access to institutional investors:* given the SFC's mindedness to limit access to ALPs to institutional investors at this stage, it is more appropriate for protection of retail investors to take the form of maintaining overall market integrity and trade information availability rather than in-depth specificity as in the context of offering or sale of investment products to retail investors. A number of requirements proposed in the draft paragraph 19 and Schedule 8 of the Code of Conduct are more akin to the in-depth specificity approach and may be unnecessary and unduly onerous for the present context. For the purpose of addressing the major mischief, it would seem more effective and efficient to focus on appropriate trade information disclosure at this stage whilst reserving the power to revise the requirements in light of market developments and prevailing circumstances.

**Question 3:** *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?*

**Law Society's response:**

We question whether the reference to "trust corporation" would not, technically, potentially allow retail investors as beneficiaries of a trust or trusts to have effective access to an ALP, if it were structured to so allow. We appreciate that a definition along these lines is typically incorporated in Type 7 licence conditions.

**Question 4:** *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?*

**Law Society's response:**

Yes, although it would be appropriate to qualify the obligation to the extent reasonably practicable to cater for offshore group members placing orders on behalf of their clients.

**Question 5:** *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?*

**Law Society's response:**

Yes, again to the extent reasonably practicable. That is more important in this case than for group companies placing orders – effectively strict liability would not be appropriate in this type of case, but reasonable steps taken would be a reasonable standard.

*Note: In all cases in respect of Q4 and Q5, there will presumably be a need to try to ensure that the person who on the face of it is the ultimate client does not have a back-to-back arrangement in place with its client to effectively circumvent the restriction? That will be difficult to police – consideration will presumably need to be given to some form of*

*guidance or regulatory obligation that is along the lines of the inter-dealer broker guidance previously published by the SFC?*

**Question 6:** *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?*

**Law Society's response:**

No comment other than to observe that given the restriction to institutional investors we do not see any particular problems with this approach given that the users can protect their own interests.

**Question 7:** *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?*

**Law Society's response:**

Yes. We would observe that given the restriction to institutional investors we do not see any particular problems with this approach given that the users can protect their own interests.

**Question 8:** *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?*

**Law Society's response:**

Yes. We would observe that given the restriction to institutional investors we do not see any particular problems with this approach given that the users can protect their own interests.

**Question 9:** *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?*

**Law Society's response:**

We have no strong view on this. We would observe that given the restriction to institutional investors we do not see any particular problems with this approach given that the users can protect their own interests.

**Question 10:** *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?*

**Law Society's response:**

No. We regard this as an example of proposed over-regulation, given that only institutional investors are intended under the proposals to be institutional in nature. We appreciate that this condition is typically incorporated in Type 7 licence conditions, but our comment relates to the principle.

**Question 11:** *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?*

**Law Society's response:**

No. We regard this as an example of proposed over-regulation, given that only institutional investors are intended under the proposals to be institutional in nature. We appreciate that this condition is typically incorporated in Type 7 licence conditions, but our comment relates to the principle.

**Question 12:** *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?*

**Law Society's response:**

No. We regard this as an example of proposed over-regulation, given that only institutional investors are intended under the proposals to be institutional in nature. We appreciate that this condition is typically incorporated in Type 7 licence conditions, but our comment relates to the principle.

**Question 13:** *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?*

**Law Society's response:**

No. We regard this as an example of proposed over-regulation, given that only institutional investors are intended under the proposals to be institutional in nature. We appreciate that this condition is typically incorporated in Type 7 licence conditions, but our comment relates to the principle.

**Question 14:** *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?*

**Law Society's response:**

We regard proper systems and controls under the broader guidelines and regulatory requirements as they stand as sufficient for these purposes, given the proposed access arrangements for ALPs for the time being. The position can be revisited as and when retail investors are to be allowed access to ALPs.

**Question 15:** *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?*

**Law Society's response:**

We consider there to be a need for licensed corporations to ensure they have proper systems and controls, including contingency plans, etc. as required under the current regime. The nature of the proposed ALP regime brings into question the need for a significant range of specific controls on operators.

*Question 16: 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?*

**Law Society's response:**

We have no strong view on this. We would observe that given the restriction to institutional investors we do not see any particular problems with this approach given that the users can protect their own interests.

*Question 17: 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?*

**Law Society's response:**

We have no objection to this requirement.

*Question 18: 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?*

**Law Society's response:**

We have no objection to this requirement.

*Question 19: 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?*

**Law Society's response:**

We consider the proposals to be overly onerous. We regard this as an example of proposed over-regulation, given that only institutional investors are intended under the proposals to be institutional in nature. We appreciate that this condition is typically incorporated in Type 7 licence conditions, but our comment relates to the principle.

*Question 20: Do you agree with the proposed periods for the keeping of these records? If not, why not?*

**Law Society's response:**

Normal record-keeping requirements should be the standard here. In the proposed paragraph 21 of Schedule 8, the reference to "comprehensive" appears particularly onerous.

*Question 21: 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?*

**Law Society's response:**

All of the requirements are catered for in the relevant legislation and broader regulatory requirements. We regard the proposals as overly onerous given the nature of the market envisaged.

In paragraphs 24 onward of the proposed Schedule 8, at least a degree of materiality would need to be built into the provisions in our view.

*Note: In relation to paragraph 60, careful consideration needs to be given as to the effect of this proposal on the Hong Kong anti-money laundering legislation, such as the Organised and Serious Crimes Ordinance suspicious transaction reporting requirements.*

**Question 22:** *Are the proposed reporting and notification requirements appropriate? If not, why not?*

**Law Society's response:**

We have no issues with the proposed transaction reporting requirements.

The notification requirements to the SFC appear overly granular, but we have no quarrel with them in the context of normal updating of the SFC in respect of major business changes. The test of materiality would be a helpful check and balance here.

The effectively enhanced "breach" reporting requirement, which goes beyond the standard set under paragraph 12.5 of the Code of Conduct appears overly restrictive – at least the concept of materiality should be considered here.

**FINAL OBSERVATION**

We consider that, where a requirement proposed in the draft paragraph 19 and Schedule 8 of the Code of Conduct is or is in substance a re-statement of a requirement that presently applies to provision of ATS or regulated activities generally, an ALP operator should be subject to the same compliance obligations as presently apply, unless otherwise expressly specified in the draft paragraph 19 and Schedule 8 (on the basis that such express provisions have been duly debated in a public consultation process).

**The Law Society of Hong Kong**  
22 April 2014

