

Stock Exchange of Hong Kong: Third Party Clearing At Last

With the introduction by the SEHK of third party clearing, brokers may delegate clearing and carrying broker functions to a third party. This development opens up the possibility for established clearing and carrying brokers and custodians to expand their scale of operations in the Hong Kong market and for brokers to focus on their core order execution franchise, leaving the clearing and, if desired, carrying functions to a third party.

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On December 3, 2007, after several years of discussions, the Stock Exchange of Hong Kong ("SEHK") introduced third party clearing.

Prior to the introduction of third party clearing, SEHK Trading Rules required Exchange Participants ("EPs") (i.e. trading members of the SEHK) to be clearing participants in the Hong Kong Securities and Clearing Company ("HKSCC"), the clearing house for the SEHK and required that all trades of an EP be cleared by the EP itself through its clearing participation in the HKSCC. All EPs would therefore act as executing broker, clearing broker and carrying broker.

The position on the SEHK contrasted locally with the position for the SEHK Options Market and the Hong Kong Futures Exchange, both of which permitted a split

between executing brokerage and clearing and carrying brokerage. More significantly, the position of the SEHK contrasted globally with international securities markets, where third party clearing has been widely permitted.

New Third Party Clearing Arrangements

Under the new third party clearing arrangements, the HKSCC will establish 2 new categories of clearing participants, namely General Clearing Participants ("GCPs") and Direct Clearing Participants ("DCPs"). As a result, EPs will have 3 options.

Maintain Status Quo

First, EPs may elect to remain (or, for new EPs, to become) clear-

ing participants of the HKSCC as DCPs, thereby acting as executing brokers as well as their own clearing brokers and carrying brokers for their own trades and those of their clients. All current EPs who are broker clearing participants of the HKSCC will automatically become DCPs.

Expand Business Scope

Secondly, EPs may elect to become clearing participants of the HKSCC as GCPs, thereby acting as executing brokers as well as a clearing and carrying brokers for themselves, other EPs and their respective clients.

Focus on Executing Brokerage

Thirdly, EPs may elect to cease (or, for new EPs, to never become) clearing participants of the HKSCC, thereby acting solely as executing brokers. In this case, an EP would enter into an arrangement with a GCP which will assume all trade settlement obligations of the EP. All trades executed by the EP would then be given-up to the GCP for settlement and clearing. A GCP would not be entitled to decline any trade so given-up.

GCP Qualifications

In light of settlement risk concerns, the HKSCC Rules establish high threshold eligibility requirements

for a GCP, which include (but are not limited to) the following:

- a GCP must be licensed or registered with the Securities and Futures Commission (“SFC”) for Type 1 (dealing in securities) regulated activity;
- a GCP must have an established clearing business in securities listed or traded on the SEHK or the financial and operational capacity to establish and operate a clearing business in securities listed or traded on the SEHK;
- in the case of a GCP that is not a bank, the GCP must either (i) maintain minimum liquid capital of HK\$300 million or more (depending primarily on its liabilities), or (ii) have minimum paid-up capital of HK\$300 million and maintain minimum liquid capital of HK\$100 million or more (depending primarily on its liabilities); and
- in the case of a GCP that is a bank, the GCP must maintain a minimum credit rating of A3 or equivalent, or be a Hong Kong dollar note-issuing bank.

A GCP may be an EP but is not required to be an EP nor is it required to hold a Stock Exchange Trading Right (*i.e.* a right to usage of SEHK trading terminals upon

approval as an EP). In other words, a GCP may, if it so chooses, focus only on clearing and carrying broker functions.

Client Relationships

Where an EP elects to settle and clear trades through a GCP, the GCP may custody the positions of the clients of the EP either on a “fully disclosed” or an “omnibus” basis. In the former, clients of the EP will open an account with the EP for execution and the GCP for clearing and carrying. In this case, as client positions are carried by the GCP exclusively, the GCP is responsible for providing back office client side services.

In the latter case, clients of the EP will only open an account with the EP. The EP will, in turn, maintain an omnibus account with the GCP. All client positions are thus carried by the EP who then carries them through the GCP. In this case, as client positions are carried by the EP, the EP is responsible for providing back office client side services. ■

TIMOTHY LOH, SOLICITORS serves as Hong Kong and International Legal Counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.

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