

## Trading Architecture Asia Keynote Address

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### Opening Words

Identifying the point in time when the moment for taking responsibility has crystallised is not straightforward. "In dreams begin responsibilities" wrote WB Yeats in early 1914<sup>1</sup>. If Yeats is right, you cannot be too early and it may be dangerous to let the moment pass and be too late.

The Securities and Futures Commission has issued a Consultation Paper on the regulation of electronic trading. The paper sets out a series of proposals designed to manage and mitigate the risks arising from trading in an automated environment but it is really about responsibilities.

Let me identify some of key issues that led to the Consultation Paper because I think its gestation is helpful in understanding the proposals and its focus on responsibilities.

### Gestation

In some respects, the full gamut of electronic trading, in particular high frequency trading, has not obtained as strong a foothold in Hong Kong as in other places. There are perhaps financial disincentives here as well as a healthy scepticism, at least in some quarters, as to whether such strategies create new efficiencies or just new problems.

Nonetheless, the growth of other electronic trading strategies in Hong Kong has been exponential over the last few years and is not likely to stop or slow down.

Since 2009, we have issued 18 Compliance Advice Letters to intermediaries following disruptive price or volume changes or other trading glitches arising mainly from algorithmic trading.

Most of the problems identified in these Compliance Advice Letters relate to algorithmic trading strategies including:

- algorithms designed for one purpose but used for another,
- algorithms designed and installed without an adequate record or any audit log of changes to their function, and
- an absence of training, supervision and compliance oversight in relation to specific algorithms.

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<sup>1</sup> *Responsibilities : Poem and a Play.* – Dundrum : Cuala Press, 1914.



Each of these problems is capable of exacerbating both the risk and the probability of misconduct.

A strong and common thread in most of these Compliance Advice Letters was a concern over the technical capacity of many intermediaries to understand and use the new technology safely.

In many cases, it was apparent the operators had little idea of what they were doing. Some excuses sounded like the trader's equivalent of the schoolboy's excuse for being late (e.g. the tram had a flat tyre).

In each of these cases, we required the intermediaries to implement remedial steps to overcome the causes. A series of micro-reforms without any explicit set of ongoing responsibilities to support them was not enough as electronic trading volumes doubled.

These new realities require a new set of responsibilities to be established within the existing regulatory framework.

### **General Observations**

Let me make a number of general observations about our proposals before summarising the main issues.

First, these proposals do not seek to impose any new obligations or responsibilities on customers: they are directed at intermediaries.

Secondly, they build on and are additional to the existing general requirements in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct). They are not a replacement for existing conduct standards.

Thirdly, they are consistent with the General Principles underpinning the whole Code of Conduct and, in this sense, they articulate what is already within the contemplation of the General Principles so far as they apply to electronic trading. In other words, our proposals make explicit in relation to electronic trading what is already implied by the General Principles.

Fourthly, they are built on experience rather than on fears. Electronic trading is not demonised.

Fifthly, the regulatory emphasis is on the responsibility of intermediaries to ensure, in effect, that new technologies remain good servants rather than bad masters.

The fifth proposition is perhaps the most important one. Intermediaries broke supply and demand for profit but, given the Code of Conduct, they also intermedate between the interests of the wider public and the market for the benefit of both.



The special force of the General Principles, especially General Principle 1 and General Principle 2<sup>2</sup>, obligates conduct that is both protective and facultative of the best interests of clients and the integrity of the market.

These observations inform the proposals set out in our Consultation Paper. Consistently with what I have said above, our proposals are concerned less with specific conduct issues and more with the way in which intermediaries manage and supervise the new technology. They are management standards for the conduct of electronic trading as opposed to a set of operational, conduct rules.

In this sense, our proposals are also typical of the highly pragmatic and robust nature and style of regulation in Hong Kong.

At the same time, we have spent a lot of time considering specific issues arising in the context of internet trading and the use of direct market access or DMA services. In addition to the experiences described in our Compliance Advice Letters, we also undertook a wide-ranging soft consultation.

The Consultation Paper reflects our experiences, in light of those conversations, and our ongoing commitment to ensuring that direct access to our market remains a privilege rather than a right or entitlement that can be shared with anyone wherever they may be.

### **Internet Trading and DMA**

At the moment, Hong Kong intermediaries do not make arrangements with clients permitting the client to use its member ID to transmit orders for execution directly to the market bypassing the intermediary's own infrastructure.

This is a state of affairs that we believe should continue and become the standard in Hong Kong.

This means intermediaries will be permitted to provide DMA services whereby clients can transmit orders electronically to the intermediaries' systems where the orders are, in turn, automatically transmitted for execution to the market under the intermediary market-member ID i.e. intermediaries' existing and ongoing pre-trade controls and oversight are applied to DMA orders before they are sent to the market.

In other words, we propose to allow DMA services to the extent that pre-trade controls and oversight are put in place by an intermediary within its infrastructure before orders are placed in the market.

We are not proposing to permit what is sometimes called sponsored access where orders are routed directly to the market bypassing the intermediaries' own infrastructure.

We are also proposing to permit sub-delegation of DMA services provided the sub-delegation is to a client that is a licensed or registered person or an overseas securities or futures dealer.

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<sup>2</sup> General Principle 1 and General Principle 2 require intermediaries to act honestly, fairly, with due skill, care and diligence in the best interest of clients and the integrity of the market.



Both the intermediary and the client will be required to have an arrangement to ensure that controls are in place to monitor the orders of the sub-delegatees and that the sub-delegatee is able to meet the intermediary's minimum client requirements.

We think this strikes the right balance between innovation on the one hand and protection of access rights to the market on the other.

We also make proposals in relation to the management of risks associated or arising from internet trading and DMA services including:

- automated pre-trade controls to prevent orders that exceed trading and credit limits and orders that are not in compliance with the regulatory requirements; and
- post-trade monitoring to identify manipulative or abusive orders.

In addition for DMA services, we propose that an intermediary should ensure that:

- a client meets required minimum standards of proficiency and competence in using the system;
- the client understands and has the ability to comply with applicable regulatory requirements and
- the client has adequate arrangements to control orders entered through the DMA services.

Let me now turn to algorithmic trading.

### **Algorithmic Trading**

As mentioned, algorithms were the subject of most of our inquiries leading up to the Consultation Paper, especially irregular and sudden price and volume changes giving rise to concerns as to intermediaries' understanding, competence and level of control over their own systems.

We are proposing that an intermediary should meet the following requirements.

First, an intermediary should establish and implement effective policies and procedures to reasonably ensure that designers and developers of algorithms are suitably qualified and that traders who use them are not only trained but are also approved to do so by the intermediary.

Secondly, an intermediary should ensure that trading algorithms, and any subsequent developments and modifications, are adequately tested in such a way so the intermediary can be reasonably satisfied that:

- the algorithmic trading system and trading algorithms will operate as designed;
- the design and development of trading algorithms takes into account foreseeable extreme circumstances and the characteristics of different trading sessions (in light of existing market conditions); and
- the deployment of trading algorithms will not interfere with the operation of a fair and orderly market.

Thirdly, an intermediary should ensure that it has effective controls to:



- monitor and prevent order instructions that may be erroneous or manipulative, or may interfere with the operation of a fair and orderly market; and
- protect the intermediary and its clients from being exposed to excessive financial risk.

Fourthly, we propose that an intermediary should also conduct regular post-trade reviews of trading activities to identify obviously suspicious manipulative or abusive activities.

Fifthly, we propose that an intermediary should keep records of the design, development, deployment and operation of trading algorithms.

### **Closing**

These proposals are very challenging ones.

They require senior management to establish new disciplines and protocols over the design and development of electronic trading systems, to identify and nurture new capabilities and levels of expertise and to apply new methods to control and supervise these activities. These proposals have been developed to make sure Hong Kong's intermediaries will be confident masters of new technology rather than its servant, or worse, its victim.

Our consultation period is still running and will end on 24 September 2012.

Your views are needed to ensure we set Hong Kong on the right path in this difficult and new area.

Thank you all.