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I-ACCESS INVESTORS LIMITED  
COMMENTS ON THE CONSULTATION PAPER  
“SFC PROPOSES TO ENHANCE THE REGULATORY FRAMEWORK  
FOR ELECTRONIC TRADING”

**Introduction**

I-Access Investors Limited (“IAI”) has been aware for years it is a trend of more investors in Hong Kong to make use of electronic trading platform to place their investment orders in the Hong Kong stock market. As a licensed corporation regulated under the Securities & Futures Commission (“SFC”), IAI realizes that it is indispensable (or inevitable) to have a regulatory framework for SFC to regulate licensed corporations over the operation of electronic trading.

SFC in the Consultation Paper (“CP”) makes references to IOSCO Final Report on Principles for Direct Electronic Access to Markets (August 2010) (“the IOSCO Report”). It appears it was on selective basis to adopt some rationales [e.g. Principle 3 (intermediary retains ultimate responsibility for all orders...) on page 19 of the IOSCO Report] mentioned in the IOSCO Report to draft the CP covering the draft Paragraph 18 of and Schedule 7 to the Code of Conduct. Certain comments and feedbacks collected from some U.S. securities practitioners mentioned in the IOSCO Report appear not mention in the CP.

**Answers to SFC Questions in CP**

SFC question no.	I-Access response (CP = the SFC Consultation Paper on Electronic Trading)
1	<p>Do you agree that the proposed scope of the regulation of electronic trading is appropriate in terms of</p> <ul style="list-style-type: none"><li>(i) the types of electronic trading, which include internet trading, DMA and algorithmic trading?</li><li>(ii) the types of products primarily covered by these proposals namely securities and futures contracts that are listed or traded on an exchange?</li><li>(iii) the persons to whom the proposals apply?</li></ul> <p><u>Answer</u> <i>We do not agree to the proposed scope of the regulation of electronic trading.</i></p> <p><i>Electronic trading involves certain persons who are not regulated by SFC, including ordinary investors, DMA clients and system service providers. Licensed corporations are to certain extent unable to monitor/control the ways investors to place their orders, the algorithmic formulae set by DMA client and the ways system services providers design trading systems for licensed corporation if these 3 parties are with illegal or criminal intent. For the persons to whom the proposals apply, corporations licensed/registered with SFC should not be the only persons</i></p>

	<p><i>under the proposed regulations. In the CP, SFC should suggest the liabilities that these 3 parties will bear if they have intention to carry out any activity that may constitute illegal or criminal offence.</i></p> <p><i>As stated in our answers to certain SFC questions listed below, many areas, terms, procedures etc require SFC to define and clarify. Provided details (including definitions of terms stated in the proposed regulations, clear mechanism of regulated activities, etc) of regulations are subsequently clearly defined and clarified, we accept reasonable regulations, but not excessive regulations.</i></p> <p><i>Instead of launching proposed regulations on electronic trading, we suggest licensed corporations who provide electronic trading service be under registration with Hong Kong Stock Exchange instead of under regulation of SFC.</i></p>
2	<p>Do you agree that an intermediary should be ultimately responsible for the orders sent to the market through its electronic trading system and for the compliance of the orders with applicable regulatory requirements? If not, why not?</p> <p><u>Answer</u></p> <p><i>IAI does not agree to the above proposed regulation. We regard the word “ultimately” in the question should be subject to comprehensive discussions.</i></p> <p><i>We consider the origin of orders is the most critical element to determine which party bears the ultimate responsibility of order placed. Investors are usually the originating party of orders placed. With minimal arrangement, investors who possess insider information or illegal/criminal intent place orders which may be accepted by trading system of a licensed corporation and HKEx. In this case, investors should be responsible.</i></p> <p><i>Further to the above, a group of investors may deliberately act as buyers and sellers of certain stock in order to manipulate the market. Licensed corporation concerned may not have any idea. Licensed corporations are not supposed to trace illegal/criminal intents of investors. Even the licensed corporation finally escapes from ultimate responsibility; it is possible that the corporation may be charged as accomplice by SFC.</i></p> <p><i>Intermediaries are not the sole party to ensure integrity of orders sent to the market. Rules set by HKEx and clearing houses, rules in the Securities &amp; Futures Ordinance, integrity of investors and quality of services rendered system vendors also play a significant and major role.</i></p> <p><i>SFC is empowered to take disciplinary actions against licensed corporations if they are in breach of SFC rules and regulations. Licensed corporations however do not have similar power to penalize clients who cause intermediaries to make violation of market rules or the SFC proposed rules on electronic trading. It is not fair.</i></p> <p><i>Based on the above arguments, licensed corporations should only be ultimately</i></p>

	<i>responsible for the house orders they placed or problem orders derived from system fault of licensed corporation.</i>
3	<p>Do you agree that an intermediary should effectively manage and adequately supervise the design, development, deployment and operation of the electronic trading system it uses or provides to clients for use? If yes, are the proposed requirements sufficient? If not, why not?</p> <p><u>Answer</u> <i>We do not agree that one responsible officer or executive officer is responsible for supervising the design, development, deployment and operation of electronic trading system.</i></p> <p><i>IT/System expertise is not a requirement for an individual to apply for RO status licensed with SFC; executive officer may not be a licensed person. It is rare in securities industry that RO or executive officer possesses IT related degree. It should spend at least years for RO or executive officer to upgrade their IT/system knowledge. How can a layman supervise the design and development of electronic trading system? It is not practical.</i></p>
4	<p>Do you agree that an intermediary should ensure the integrity of the electronic trading system it uses or provides to clients for use, including the system's reliability, security and capacity, and have appropriate contingency measures in place? If yes, are the proposed requirements sufficient? If not, why not?</p> <p><u>Answer</u> <i>Two terms shown in paragraph 35 of CP are vague--"reliable techniques" and "need-to-have basis". They need specific explanations.</i></p> <p><i>Paragraph 38 of CP states all records should be backed up in and off-line medium. Please provide details. What media is required to use for back up purpose? How many back-up records are considered sufficient?</i></p> <p><i>If the above has been defined/clarified, we agree to that an intermediary should ensure the integrity of electronic trading system.</i></p>
5	<p>Do you agree that an intermediary should keep, or cause to be kept, proper records on the design, development, deployment and operation of its electronic trading system? If not, why not?</p> <p><u>Answer</u> <i>Intermediaries have to keep comprehensive documentation of the design, development, deployment and operation of the electronic trading system. Please specify how "comprehensive". When it is clarified, we agree to the proposed regulation.</i></p>
6	Do you agree with the proposed periods of record keeping?

	<p>If not, why not?</p> <p><u>Answer</u>  <i>We agree with the proposed periods of record keeping.</i></p>
7	<p>Do you agree that, in providing internet trading or DMA services, the proposed pre-trade controls should be put in place by an intermediary?  If yes, are the proposed requirements appropriate? If not, why not?</p> <p><u>Answer</u>  <i>In paragraph 44 of the CP, it does not specify how “reasonably designed” of automated pre-trade controls. No guideline is given. It appears SFC is a proper regulator to establish clear criteria of pre-trade controls for intermediaries to incorporate such into their trading systems.</i></p> <p><i>Currently, if an order is considered “erroneous”, e.g. price and quantity outside the acceptable range, HKEx will not accept the order. The level of detection depends on how sophisticated the trading system designed by intermediaries or system service vendors. So far there are no concrete regulations/guidelines on this aspect.</i></p> <p><i>Subject to the above, we agree to the proposed pre-trade controls.</i></p>
8	<p>Do you agree that, in providing internet trading or DMA services, an intermediary should conduct post-trade monitoring to reasonably identify any order instructions and transactions which may be manipulative or abusive in nature?  If not, why not?</p> <p><u>Answer</u>  <i>It is critical to provide the definitions of “manipulative or abusive” orders. How frequent, how many and how much of orders are defined as “manipulative or abusive”? Without the definitions, it is very difficult for licensed corporations to observe this proposed regulation.</i></p> <p><i>SFC should provide clear guidelines for the monitoring. The electronic trading system of our company handles thousands of orders. Without guidelines, we may experience compliance difficulty. Also, SFC should consider a realistic situation that licensed corporations may incur extra costs on carry out this monitoring.</i></p> <p><i>SFC has been regarded as an authority to monitor manipulative or abusive orders (pre- or post-trade orders) in the market. If SFC intends to cast the responsibility (or burden, if correctly classified) to licensed corporations, many of them may not survive in the market because of increase of monitoring costs.</i></p> <p><i>We do not agree to the proposed regulation until the above have been cleared.</i></p>
9	<p>Do you agree that an intermediary should establish minimum client requirements for its DMA services and assess whether each client meets the requirements before granting DMA services to a client?</p>

	<p>If not, why not?</p> <p><u>Answer</u>  <i>It is redundant for intermediaries to establish minimum requirements for DMA access. The party who is able to access and use DMA has to pass the test imposed by HKEx which has measures regulating order price and quantity amount.</i></p> <p><i>Words (like “appropriate”, “client understands”, etc) in paragraph 2.2.1 of Schedule 7 are vague. Who is the appropriate person/party to set the minimum requirements for DMA services? Without clear definitions and guidelines, how can licensed corporations claim it is sufficient and adequate?</i></p> <p><i>We will not agree the said requirement until the above are cleared.</i></p>
10	<p>Do you agree that an intermediary should not allow its client to sub-delegate the DMA services to another person unless the client is a licensed or registered person or an overseas securities or futures dealer? Do you agree with the proposed definition of “overseas securities or futures dealer”?</p> <p>If not, why not?</p> <p><u>Answer</u>  <i>We do not agree to both questions.</i></p> <p><i>Theoretically an intermediary may stipulate a DMA client to sub-delegate the DMA services to other licensed/registered persons. In practice, the intermediary it is very difficult to implement. DMA client may not be a licensed person. There is only contractual relationship between the intermediary and the DMA client. When there is any breach of SFC rules derived from DMA orders, the intermediary will be the only person to be penalized. For instance, Bloomberg can sub-delegate the DMA service to their clients. Though Bloomberg is supposed a high self-regulated service provider, the company is not regulated by SFC. Bloomberg appears not liable if there is problem with orders placed by sub-delegated clients.</i></p> <p><i>Concerning the proposed definition of “overseas securities or futures dealer”, even definition similar to Type 1 or Type 2 regulated activity is assigned to it, such securities or futures dealer is outside the jurisdiction of SFC. Regulation on the sub-delegated clients appears meaningless and useless.</i></p>
11	<p>Do you agree that an intermediary should establish and implement effective policies and procedures to reasonably ensure that persons involved in the design and development of, or approved to use its algorithmic trading system and trading algorithms are suitably qualified?</p> <p>If not, why not?</p> <p><u>Answer</u>  <i>Our answer is yes. But the question is it may take months for intermediaries to establish the policies and procedures.</i></p>
12	<p>Do you agree that an intermediary should ensure that the algorithmic trading</p>

	<p>system and trading algorithms it uses or provides to clients for use are adequately tested to ensure that they operate as designed at all times? If not, why not?</p> <p><u>Answer</u> <i>We agree.</i></p>
13	<p>Do you agree that an intermediary should have effective controls to ensure the integrity of its algorithmic trading system and trading algorithms and that they operate in the interest of the integrity of the market? If yes, are the proposed requirements for risk management sufficient? If not, why not?</p> <p><u>Answer</u> <i>It is inevitable to have loopholes in any trading system and trading algorithms maintained by intermediaries. Intermediaries can only try to operate in the interest of the integrity of the market as the intermediaries consider sufficient. When talking about pre-trade controls, the IOSCO Report (at the bottom of p.20) says that controls “should be a matter for determination by the market, market intermediaries, clearing firms, and market authorities.” We apply similar rationale that intermediaries should try their best to ensure the integrity of algorithmic trading system and trading algorithms but should not be the sole party to take the blame when loophole does exist.</i></p> <p><i>Again, without the definition of “manipulative or abusive orders”, intermediaries are unable to comply with the proposed requirements.</i></p> <p><i>Subject to the above, we agree that an intermediary should have effective controls to ensure integrity of algorithmic trading system and trading algorithms.</i></p>
14	<p>Do you agree that an intermediary should keep, or cause to be kept, proper records on the design, development, deployment and operation of its algorithmic trading system and trading algorithms? If not, why not?</p> <p><u>Answer</u> <i>In paragraph 3.4.1 of Schedule 7, processes taken (e.g. trial and error testing) in “design and development” may not be “documented and recorded in writing”. It is too demanding to ensure a “complete audit trail” when no clear guideline and definition are given. Similarly, the same rationale applies to “records of all the parameters” as mentioned in paragraph 3.4.2.</i></p> <p><i>“the parameters” stated in paragraph 3.4.2 should be clearly defined because “parameter” may have different meanings to different system technicians.</i></p> <p><i>SFC should consider DMA client in this proposed regulation. Intermediary is not empowered to request DMA clients to provide the required records by reason of confidentiality. There is only contractual relationship between the two parties. Failing to provide by DMA clients may only constitute a breach of contract; but</i></p>

	<p><i>the intermediary may be penalized by SFC.</i></p> <p><i>Subject to the above, we agree that an intermediary should keep the records.</i></p>
15	<p>Do you agree with the proposed periods of record keeping and details of the records to be kept? If not, why not?</p> <p><u>Answer</u> <i>Maintaining two-year records is reasonable.</i></p>
16	<p>Do you agree that where an electronic trading system is provided by third party service provider, an intermediary should perform appropriate due diligence to ensure that the intermediary meets the proposed requirements set out in paragraph 18 of and Schedule 7 to the Code of Conduct in its use of the system? If not, why not?</p> <p><u>Answer</u> <i>When intermediaries require third party service providers to provide electronic trading systems, it is very likely the intermediaries are lack of IT or system design experts to ascertain integrity of the systems. In practice, intermediaries are unable to perform the above said due diligence.</i></p> <p><i>Intermediaries usually test the systems designed by service providers in the capacity of users. They can by no means test upon and guarantee that the implicit details of the designed systems. Intermediaries know the ways to make use of the designed systems, but never know details of the designs.</i></p> <p><i>There is contractual relationship between intermediaries and service providers. Termination of this relationship may affect the continuity or on-going operation of the already designed systems. When it does happen, how can intermediaries perform due diligence?</i></p> <p><i>Subject to the above, we agree to the proposed requirements.</i></p>
17	<p>What is your view on requiring an intermediary to make arrangements with a service provider for the purpose of meeting the proposed requirements on record keeping?</p> <p><u>Answer</u> <i>No SFC rule can make service providers obliged to follow the proposed requirements on electronic trading though they are supposed to follow instructions of intermediaries. It is a legal matter. Intermediaries have to face consequence if arrangements with service providers cannot satisfy the requirements.</i></p> <p><i>Intermediaries can make contractual agreement with service provider regarding the issue, but there is no guarantee that service provider will deliver the services. Intermediaries may claim compensation according to the agreement. However, the</i></p>

*most important concern is, SFC is not empowered by Securities and Futures Ordinance to regulate the service providers. It is questionable that regulating service provider is under the jurisdiction of SFC. We suggest SFC find ways to regulate service providers instead of only regulating intermediaries on this issue.*

*Concerning the record keeping requirement, service provider may provide service for certain period of time, but not for good. Intermediaries concerned may from time to time face problem in satisfying this record keeping requirement.*

### **Conclusion**

IAI basically agree there should be regulations/guidelines to regulate the increasing growth of electronic trading transactions. The CP however appears to cast substantial part/burden of monitoring burden on intermediaries who have sizeable limitations/constraints to comply with the proposed Paragraph 18 of and Schedule 7 to the Code of Conduct. Our suggestion is to ask SFC (i) re-define the sharing of responsibilities, (ii) consider the considerable amount of costs that intermediaries may bear to satisfy the proposed requirements and (iii) ponder the difficulties/problems that intermediaries may have in compliance with the proposed requirements.

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