

15th September 2012

The Commissioner
Securities and Futures Commission
8 /F Chater House
8 Connaught Road
Central
Hong Kong

Dear Sir,

SFC Consultation on the regulation of electronic trading

Optiver is pleased to provide the following comments on the propose regulation of electronic trading rule released by the SFC on 24th July 2012.

Optiver is a strong supporter of initiatives which promote market integrity and in particular improve risk management of electronic trading.

Executive Summary

We agree with the broad and implied direction of regulation contained in this consultation. At the structural level the proposals in this consultation contain some imbalance of principles and rules. At the definitional level we believe a number of proposed solutions may lack sufficient clarity for successful implementation.

We note the simultaneous consultation being conducted in Australia with respect to electronic trading contained in CP 184. We believe that there is a risk of inconsistency in approach between key regulatory jurisdictions in the Asia Pacific region with these proposals in their current form. We believe that the SFC Consultation may benefit from being considered more closely in light of CP 184.

The following summary comments are provided:

- The section regarding responsibilities for orders does not sufficiently address or include equally important issues concerning the responsibilities of Exchanges.
- Filter requirements are approached on the basis of reasonableness however do not sufficiently address risk from a market integrity perspective.
- Proposals for testing are open ended and undefined and are not appropriately focussed on the potential impact on risk and market integrity.
- Risk management proposals contain vague and open ended requirements. The approach of including financial risk within risk management rules is not efficient. Market manipulation rules may become confused with risk management rules.
- Requirements for record keeping are not clear. We note the CP 184 approach to documentation which has a very practical focus to “document according to nature scale and complexity”. This compares to totally exhaustive and overly prescriptive terms such as “complete audit trail” or “all the parameters”.



Background to Optiver

Optiver is a global electronic market maker, providing liquidity in markets in Europe, the U.S. and the Asia Pacific region. Optiver Trading Hong Kong Limited is one of Hong Kong's largest Market Makers and provider of liquidity to the Hong Kong exchanges. Our trading strategies utilise real time information, advanced technology, transparent risk management systems and continuous innovation. By doing so Optiver adds value for the investing public in Hong Kong.

Technology Requirements for Market Makers

High speed management of orders and messaging is a necessary requirement of market making. Given that Market Makers are required to continuously quote, and subsequently instantaneously hedge, any movement in the underlying market needs to be updated in a Market Maker orders. Because markets move so rapidly, high speed movement of quotation messages including orders and re-booking is completely unavoidable and a necessary part of risk management in the provision of liquidity. A Market Maker must continually quote and hedge because it has no natural counterparty. This requires that a Market Maker will necessarily have automated low latency systems to facilitate order activity.

Question 1 – Scope of the proposal

We support the proposed scope of the regulation of electronic trading to cover all participants and all exchange listed products such as securities, futures, options and other derivatives.

Question 2 – Responsibility of Orders

We believe there needs to be a clearer and more integrated framework to distinguish between the responsibilities of exchanges and the responsibilities of participants of exchanges.

Exchange Market Operators should take a far more active and involved role in providing infrastructure and control capabilities. Currently there is a lack of clarity and sophistication as to filter responsibility and how this ties in with market integrity rules. Exchange Market Operators we believe currently have little responsibility for preventing disorderly markets. There must be a more thorough analysis on the required responsibilities between Market Participants, Market Operators and Securities Commissions on interconnected issues such as filter threshold types and fair and orderly market requirements.

Question 3 – Management and Supervision

We believe the term "erroneous" is unclear and may unnecessarily capture inadvertent errors which have impact on market integrity.

We note the requirement that "all modifications... are adequately tested". This is an unworkable proposal and instead it should take into consideration the risk to fair and orderly markets.

The requirement to "report..any material service interruption" requires further definition. What does "material" mean? This area would better be phrased to refer to the impact on fair and orderly markets.

Question 4 – Systems Reliability

Agree

Question 5 & 6 – Record Keeping

Agree.



Question 7 & 8 – Pre-Trade and Post-trade Controls

Agree. Additionally we believe that the “reasonableness” requirement should be strengthened with a requirement that controls be commensurate to the risk to market integrity. Refer also to Question 2 response above.

Question 9 & 10 – KYC and DMA sub-delegation

Agree

Question 11 – Suitable Qualifications

Agree

Question 12 – Testing

We believe that the broad principle described for testing only is correct. The requirement for annual internal review and testing is also appropriate. However the proposal is not suitably framed and addresses testing requirements inadequately:

The question itself is not well worded. “Do you agree that an intermediary should establish and implement effective policies and procedures to reasonably ensure...” This question might better read “Do you agree that an intermediary should implement policies and procedures to reasonably ensure...”. The word “effective” is confusing and unclear. “Effectiveness” is already implied in order to “reasonably ensure”.

Paragraph 55 is not suitably drafted. The second bullet point reads:

- “the design and development of the algorithmic trading system and trading algorithms have taken into account foreseeable extreme circumstances and the characteristics of different trading sessions...”

We believe the requirements of this paragraph lack sufficient definition and are open to interpretation.

What is a “foreseeable”? Current market conditions and trading opportunities make this point very unclear and imprecise to implement. What is a “foreseen extreme circumstance” compared to an unforeseen extreme circumstance? This is potentially poor regulation which will be very hard for an exchange participant to implement and a regulator to administer. The more appropriate way to address this subject is to consider a risk based approach.

How do “extreme circumstances” fit in with the existing exchange requirements to manage extreme price movements? How does this fit in with existing market integrity rules?

Also, is the term “extreme” intended to extend beyond these existing rules and if so how is to be defined?

We suggest taking the second bullet point out of the proposal.

The key requirement of testing will be met sufficiently with the third bullet point “...would not interfere with the operation of a fair and orderly market”. This definition in itself will cover all circumstances and requirements.

Question 13 – Risk Management

We believe that the broad principle described is appropriate however some of the detailed requirements are unsuitable. Specifically we believe that both bullet points of paragraph 59 are not suitably drafted.

- monitor and prevent the generation of or passing to the market for execution order instructions from its algorithmic trading system which may be erroneous, manipulative or abusive, or interfere with the operation of a fair and orderly market; and
- protect the intermediary and its clients from being exposed to excessive financial risk.

In the first bullet point, the phrase “may be erroneous” is not suitable and unnecessarily imposes a breach condition of regulations in events where there is neither an element of intention nor market impact. For example, a simple fat finger error which has no market impact or intention might be considered a breach under these proposals. If such erroneous order is a breach of rules, then this unfairly regulates participants. This phrase should be removed entirely.

The phrase “manipulative or abusive” does not belong in risk management rules. This area of regulation is separately addressed in the existing market manipulation rules of the SFO. Including such requirement in risk management rules has the potential to make market manipulation rules contradictory or ineffective.

The first bullet point would better read as “monitor and prevent the generation of or passing to the market for execution order instructions from its algorithmic trading system which may interfere with the operation of an orderly market.”

The second bullet point should be removed entirely as a proposal in its current form. Protecting principals and clients from financial risk is covered already in existing licensing and competency requirements with respect to financial resources of a licence holder and separately client responsibilities of intermediaries. What is meant by the term “excessive” financial risk? This is inadequately defined and open for mis-interpretation. We note that ASIC CP 184 addresses the topic of financial risk in a more practical and balanced way. Paragraph 78 of the draft document CP 184 states “should take into account financial and trading risks in addition to the regulatory risks...” and we believe this is a better approach

Question 14 – Record Keeping

We agree with the principle of proper record keeping. However we believe that the detailed proposals are not workable or practical.

Paragraph 62 contains a number of inadequate proposals. The first and second bullet points state:

- a complete audit trail of the design and development...
- records of all the parameters which its algorithmic trading system and trading algorithms..

In the first bullet point, the term “complete audit trail” inadequately defines the requirements of documentation and the of recording risk management. The real issue at hand is the adequacy of documentation. This approach is in effect imposing a completeness test which is quantitative and qualitative criteria are ignored.

In the second bullet point the term “records of all the parameters” is an inappropriate definition. What is meant by “all the parameters”?

In the practical sense a parameter can be a minor setting or feature of a simple trading system. For example in the normal course of a simple correlation trading strategy parameters may be changed which have no impact on market integrity risk. If a parameter is defined to include a simple business as usual trading feature, it would be impossible to track the use of such simple features.



A parameter might also be defined as a wider and more important setting on a filter which can significantly open up order flow or price and volume impact. In this case records would be expected to be kept in accordance with the potential impact of risk.

We note that ASIC CP 184 has addressed these definitional issues relating to record keeping and audit trails in a more effective way.

In paragraph 93 of CP 184 Attachment 2, ASIC uses the approach “system design documentation should be tailored to the nature, scale and complexity of the market participant’s business”.

Paragraph 40 of CP 184 Attachment 2 requires records to be kept of parameter changes specifically in relation to filters.

Paragraph 90 of CP 184 Attachment 2 refers to resources to manage change on a principles basis

Paragraph 56 of CP 184 Attachment 2 refers to managing the origin of orders on a principles basis.

Question 15 – Proposed Periods

Agree

Questions 16 & 17 - Third party development of the electronic trading system

Agree.

Draft Schedule 7 of the Code

- 1.2.1 “A licenced.. has effective controls...” Remove the word “effective” - controls are being specifically defined to a function anyway.
- 1.2.2 “System Reliability” – refer to question 4 response above.
- 1.3 “Record keeping” refer to question 14 response above.
- 2.1 “Risk Management” refer to question 13 response above.
- 3.2 “Testing” refer to question 12 response above.
- 3.3 “Risk Management” refer to question 13 response above.
- 3.4 “Record keeping” refer to question 13 response above.

Conclusion

Optiver welcomes the initiatives contained in this consultation. We believe however that there are significant drafting issues to be considered in Draft Paragraph 18 and Draft Schedule 7 of the Code if the proposals are to be implemented in a successful way.

We look forward to providing any further discussion and clarification on this subject matter. Please do not hesitate to contact Steven McCartney on +61 2 9275 6131 or email: steven.mccartney@optiver.com.au if you have any further question.

Yours Sincerely



Steven McCartney
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