



September 23, 2012

Via Electronic Submission: electronic_trading@sfc.hk

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

Re: Consultation paper on the regulation of electronic trading

Dear Sir or Madam:

Managed Funds Association¹ (“MFA”) appreciates the opportunity to comment on the Securities and Futures Commission’s (the “Commission”) consultation paper on the regulation of electronic trading (“Proposed Regulation”).² MFA members have a strong interest in markets that operate efficiently and with integrity, and supports efforts to implement a robust regulatory framework that fosters innovations in technology and promotes greater competition among marketplaces. We are strong proponents of advancements in technology in the markets, which have empowered investors, both institutional and retail, with more efficient methods to access the markets and execute their investment strategies globally. The markets of the 21st century are largely, and will become ever more, interconnected and the need for technology will only increase. We believe that market participants and regulators should take responsible steps to prepare for this continuing market evolution. Accordingly, we appreciate the Commission’s proposed regulatory requirements for intermediaries to manage and mitigate the risks that arise from trading in an automated environment, and offer the below comments on the consultation paper.

¹ The Managed Funds Association (“MFA”) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

² Hong Kong Securities and Futures Commission (“SFC”) Consultation paper on the regulation of electronic trading, 24 July 2012, available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP3>.

I. Overview

In regulating electronic trading, we believe there should be an important distinction between an intermediary/vendor that provides electronic connectivity services (*i.e.*, connectivity and routing access to liquidity centers) and an end-user, such as a Fund Manager, who uses such service. An intermediary should be held to a higher standard with regard to electronic trading because it is selling electronic connectivity services/technology to the public; and as the access point to an exchange or other market centers, presents greater financial risk. An end-user should be responsible for technology, such as software programs, it develops to implement its trading strategy. An end-user should be held to a different standard, however, because its trades will be filtered through an intermediary's electronic trading system.³ As such, an end-user's trading activity will be less likely to cause market disruptions and will present less financial risk to the financial system. Moreover, few end-users have extensive infrastructure, like intermediaries, for it to be feasible for them to implement the requirements of the Proposed Regulation.

Q1. Do you agree that the proposed scope of the regulation of electronic trading is appropriate in terms of (i) the types of electronic trading . . . (ii) the types of products . . . (iii) the persons to who the proposals apply?

The scope of the Proposed Regulation should cover all forms of electronic trading/connectivity services provided by an intermediary. In this respect, we believe it is appropriate for the Proposed Regulation to cover the following technology/services provided by an intermediary: internet trading; direct market access ("DMA"); and algorithmic trading. We agree that the types of products covered should be all exchange-traded securities, futures contracts and products.

We believe the Proposed Regulation should apply to intermediaries with market access (and any other direct exchange members) as they are the gatekeepers to the markets; and as such, they present a greater level of risk and should bear a higher level of responsibility. The Proposed Regulation is helpful in outlining the responsibilities and obligations of an intermediary. The standards set in the Proposed Regulation, however, should not apply to an end-user, such as a Fund Manager.⁴ A Fund Manager, unlike an intermediary, does not have a service-provider—client relationship, but is governed by its fiduciary responsibility to its investment fund. Also, a Fund Manager as an end-user presents less risk to the financial markets because its trades go through an intermediary. We believe the intermediary, as the gatekeeper to the markets, should filter all trades through pre-trade risk controls.⁵

³ As discussed in our letter, we fully support the requirement that an intermediary implement pre-trade risk controls.

⁴ Proposed Regulation p. 37, Appendix D.

⁵ See letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, to the Honorable Mary Schapiro, Chairman, Securities and Exchange Commission ("SEC"), August 14, 2012, on Computer Trading & Risk Management Issues, *available at*: <https://www.managedfunds.org/wp-content/uploads/2012/08/Risk-Management-8-14-12-final.pdf>. See also letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, to Ms. Elizabeth M. Murphy, Secretary, SEC, March 29, 2010, File No S7-03-10, *available at*: [600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | \[www.managedfunds.org\]\(http://www.managedfunds.org\)](https://www.managedfunds.org/wp-content/uploads/2010/03/MFA-</p></div><div data-bbox=)

We respectfully suggest that the Proposed Regulation should include a new section that addresses the requirements of end-users. We agree that Fund Managers as end-users should have standards with respect to electronic trading and we believe that the Commission should tailor such standards to the end-user market. End-users should be subject to a different standard than intermediaries. End-users should take reasonable steps to insure that technology they have developed is tested and functioning as designed prior to use; and they should have appropriate recordkeeping. We believe the Commission should create an advisory committee of buy-side participants to work with the Commission to develop standards and best practices for end-users.

Q2. 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?

MFA believes that an intermediary providing service through its electronic trading system should be ultimately responsible for the orders sent to the market and for the compliance of the orders with applicable regulatory requirements, outside of willful misconduct.

Q3. 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?

MFA agrees that an intermediary should effectively manage and adequately supervise the design, development, deployment and operation of the electronic trading system/electronic connectivity service it uses or provides to clients for use. We do not believe, however, that intermediaries should be the exclusive provider of electronic trading technology, execution tools or risk management systems. An intermediary should be allowed to make arrangements for a third party to develop technology for the intermediary or its clients' use. Of course, the intermediary should perform appropriate due diligence before use of such products provided by a third party service provider.

Q4. 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?

MFA believes it is paramount that an intermediary has controls in place to prevent its electronic trading system from generating and sending orders to the market that may be erroneous or not compliant with the applicable regulatory requirements. We also believe that an intermediary adequately should test its trading system for reliability and trading capacity, and employ adequate and appropriate security controls. An intermediary should be held responsible for the technology/product it employs. Accordingly, we believe the Proposed Regulations should require an intermediary to take reasonable steps to promote the integrity of the electronic

Comments-on-BD-Risk-Mgmt.3.29.10.pdf. We note that the SEC was concerned that customers, such as hedge funds, would have "naked sponsored access" to an intermediary's trading systems without appropriate protections. MFA supported the framework of Rule 15c3-5, Risk Management Controls for Brokers or Dealers with Market Access, to address that basic concern.

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.

Q5. 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?

MFA agrees.

Q6. Do you agree with the proposed periods of record keeping? If not, why not?

MFA agrees.

Q7. 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?

MFA supports the proposal to require an intermediary to implement automated pre-trade controls with respect to DMA services. In fact, we believe the types of pre-trade controls should be standardized across marketplaces, and even globally. In this way, intermediaries with international affiliates may build upon existing technology; the number and types of pre-trade controls should not become a competitive issue among intermediaries; and end-users would be subject to the same minimum latency.

We believe an intermediary should have full and exclusive control of its automated pre-trade controls, including the ability to monitor and adjust the controls in real-time. In our view, it shouldn't matter however, which entity develops the risk management technology used by the intermediary. Technology developed by independent third parties, by customers or entities affiliated with customers can be just as effective as technology developed by intermediaries. In such instances, an intermediary should be required to validate and test the technology prior to utilization. In other words, an intermediary should have the same responsibility to oversee its trading technology, whether it develops and employs the technology in-house, or uses a third party vendor to provide that functionality.

Permitting flexibility in the implementation of risk management controls will allow for and encourage greater competition and technological innovation that will enhance the ability of customers to more effectively execute their orders and obtain best execution.

Q8. 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?

MFA supports the proposal that an intermediary conduct post-trade monitoring to reasonably identify any order instructions and transactions which may be manipulative or abusive in nature. The Commission should re-emphasize the need for intermediaries to maintain

information barriers between an intermediary's purely proprietary trading businesses and customer-facing trading businesses. To enhance investor protection, we believe the Commission in finalizing the Proposed Regulation should reinforce and remind intermediaries to respect and comply with their existing regulatory responsibilities and any additional contractual obligations to protect the confidentiality of customer orders. We believe this is especially relevant when the execution infrastructure provided by an intermediary is the same for both proprietary and client market connectivity.

Q9. 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? If not, why not?

MFA supports the proposal that an intermediary establishes minimum client requirements for its DMA services and assesses whether each client meets the requirements before granting DMA services to a client. We support the minimum requirements in the Proposed Regulation, but otherwise believe that an intermediary should have the flexibility to establish its own minimum client requirements for DMA services.

Q10. 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"? If not, why not?

We believe a distinction should be made between an end-user granting access to a few different individuals within its organization and an end-user sub-delegating its DMA services to unaffiliated persons outside of its organization. We believe the former access is an acceptable practice and generally covered in the DMA services contract between an intermediary and end-user. An end-user generally makes a number of representations and warranties in such contract and agrees to take responsibility for all trades executed through its DMA service.

With regard to a client sub-delegating DMA services to an unaffiliated person outside of its organization, we believe such assessment should be left to an intermediary as the intermediary is ultimately responsible for orders provided through its connectivity services. Nevertheless, we believe that the client should not be permitted to discharge itself of responsibility for orders placed through DMA services by sub-delegating the DMA services. In other words, we believe the client should be ultimately responsible for all orders placed through its DMA service line and that it should not be able to eliminate such obligation by delegation or contract.

Q11. 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? If not, why not?

We believe it may be difficult to have specific proficiency or qualification standards in place with respect to technology development, especially given how quickly technology becomes

outdated. A better control may be to require an intermediary to test its algorithmic trading system and trading algorithms. Such testing should be conducted both independently and through integrated or holistic testing where a firm's software interacts with others.

Q12. Do you agree that an intermediary should ensure that the algorithmic trading 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?

MFA believes that an intermediary should engage in routine testing of new or modified trading software. In the U.S., many, if not all, exchanges provide market participants a test facility to test trading software and algorithms, as well as offer test symbols/stocks to trade. In addition to individual testing, exchanges or liquidity centers also should offer integrated or holistic testing where a firm's software interacts with others. We believe it is important for testing of critical software to become more routine practice, especially testing the process for the suspension of a particular algorithm or trading software in the event an issue arises in a live environment.

Q13. 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?

MFA believes that an intermediary should have effective controls with respect to its algorithmic trading system and trading algorithms. In addition, for an electronic trading system, MFA believes there should be at least one designated principal who is available and authorized at all times to suspend all or part of the firm's trading program in the event of a trading or software malfunction. Such a person should be "on duty" anytime the firm is trading and should have sufficient information flow to ensure appropriate action. MFA believes that it is important that intermediaries have "plan-of-action" protocols including scenarios that include timely trading suspension based on specific software malfunctions or general disaster recovery events. Firm principals should have the ability through a "kill-switch" to turn off the trading program. Firms should periodically test the kill-switch.

Q14. 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?

MFA agrees that an intermediary should keep proper records on the design, development, deployment and operation of its algorithmic trading system. As discussed above, we believe that an intermediary that is offering a product—whether it's electronic connectivity services or execution algorithms—should have responsibility that the product functions as expected.

Q15. Do you agree with the proposed periods of record keeping and details of the records to be kept? If not, why not?

MFA agrees.

Q16. 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?

MFA agrees. Intermediaries should not be the exclusive provider of electronic trading technology, execution tools or risk management systems. Intermediaries should, however, perform appropriate due diligence before use of such products provided by third party service providers. We believe intermediaries should be ultimately responsible for orders sent to the market and that they should not be able to eliminate such obligation by delegation or contract.

Q17. What is your view on requiring an intermediary to make arrangements with a service provide for the purpose of meeting the proposed requirements on record keeping?

MFA believes that both an intermediary and an end-user/Fund Manager should have flexibility in determining how they will meet the record keeping requirements.

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MFA appreciates the opportunity to provide the Commission with comments on the Proposed Regulation. We would be happy to discuss further our comments with the Commission or its staff. If you have any questions, please contact the undersigned or Jennifer Han, Associate General Counsel, at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
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