



**VIA ELECTRONIC MAIL**

24 September 2012

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

Dear Sir,

**Re: Consultation paper on the regulation of electronic trading**

The Hong Kong Mercantile Exchange Limited (“HKMEX”) appreciates the opportunity to submit this letter in response to the consultation paper on the regulation of electronic trading (“Consultation Paper”) issued by the Securities and Futures Commission (“SFC”) in July 2012.

**General**

HKMEX is authorized by the SFC pursuant to the Securities and Futures Ordinance to provide automated trading services in Hong Kong. Specifically, HKMEX presently offers trading of USD Gold and USD Silver Futures Contracts on its trading platform and has designated LCH.Clearnet in London as its clearing house to clear and settle the futures contracts executed on HKMEX.

In view of advanced technological developments in electronic trading and recent market events in the global financial markets, HKMEX supports the concept of prescribing standards to govern electronic trading. This effort is consistent with HKMEX’s objective to operate a fair and orderly futures market. At the same time, technological developments will continue to evolve and as such, HKMEX believes it is also imperative that requirements imposed should provide flexibility to encourage continuing technological innovations and should not be too burdensome to restrain market developments. Other specific comments on the Consultation Paper are set forth below.



### **Scope of Direct Market Access (“DMA”)**

In the Consultation Paper, it is proposed that arrangements to facilitate DMA without going through an intermediary’s infrastructure be prohibited. This proposal appears to be based on observations that pre-trade risk controls may not be effectively implemented.

HKMEX understands that certain institutions demand DMA services without passing through an intermediary’s infrastructure. This is because these institutions may prefer to develop an interface between their own proprietary front-end applications directly with the exchange trade-matching system. In addition, DMA services may be provided by a third-party system vendor whose system may not be used by the intermediary. These firms may, therefore, prefer not to pass their orders through the intermediary’s infrastructure.

HKMEX agrees that it is crucial to put in place pre-trade risk controls over DMA activities. This requirement is, in fact, prescribed in HKMEX Rule 4.9.12 which requires, inter alia, that an HKMEX Member (as defined in the HKMEX Rulebook) should put in place appropriate pre-trade risk management controls to monitor the trading of Direct Access Clients (as defined in the HKMEX Rulebook). To facilitate HKMEX Broking Members to provide such DMA services, in addition to risk managements controls which such Broking Members may have, HKMEX also makes available pre-trade risk management controls whereby Broking Members are capable of implementing trading and position limits on their clients who connect and send orders directly to HKMEX’s trade-matching system. HKMEX also understands that certain third-party vendors provide similar functions to, and many exchanges also have tools made available for use by, market participants.

In light of the availability of the risk management controls mentioned above, the key issue is therefore whether orders are in fact “filtered” by the intermediary for risk management purposes prior to entering the exchange trade-matching system. Provided that orders are “filtered”, it may not be necessary to impose such restrictions on markets and therefore market participants may determine the means of direct access of their own choice based on commercial terms.



### **Sub-delegation of DMA Services**

Where an intermediary allows its clients to sub-delegate the DMA services to another person, it is proposed that the intermediary and its clients should, among others, ensure that the orders flow through the systems of the clients. For the reasons set forth above under "Scope of Direct Market Access", it is not necessary to impose such requirement.

It is also proposed that such person meet the minimum client requirements and a written agreement be put in place between the client and such person. However, where the client opens an omnibus account with an intermediary, the intermediary typically has no information or contact with the ultimate beneficiaries for commercial reasons. As a result, there may be practical difficulties in meeting this proposed requirement.

### **Responsibility for Orders**

The Consultation Paper points out that it is not the SFC's intention to hold an intermediary liable for all market misconduct that may involve orders that go through its electronic trading system. HKMEX agrees with this policy intention and recommends that this intention be clarified in more detail so that HKMEX and market participants may develop rules or compliance procedures where appropriate to meet the requirements.

### **System Controls**

It is proposed that an intermediary should have, among others, effective controls to enable it to cancel unexecuted orders. HKMEX is of the view that there is no single set of rules that could be implemented given the diversity of the background of exchange members and their respective clientele. Each member's business requirements should instead be analysed on individual basis for the purpose of determining the appropriate system controls that should be put in place. Please note that as a contingency arrangement, HKMEX may cancel a Member's outstanding orders at request of the Member. This arrangement (and any other arrangement which may be put in place) should be taken into account when considering the effectiveness of controls put in place by an intermediary which is an HKMEX Member.

### **Remote Members**

Separately, the SFC has previously consulted the market on remote membership of exchanges whereby overseas firms meeting the prescribed standards may become



members of an exchange in Hong Kong. These remote members may connect and send orders directly to an exchange trade-matching system. While this issue may not directly relate to this Consultation Paper, the risk management issues arising from the consultation on remote membership may be addressed under the current proposal. As noted in HKMEX's earlier correspondence with the SFC on this topic, remote membership would broaden the product distribution channels of Hong Kong markets and is consistent with global market practices. HKMEX would encourage the SFC to re-consider the proposal on remote membership at the same time.

HKMEX appreciates the SFC's consideration of our comments set forth above. Should SFC staff have any questions or wish to discuss the issues further, please contact Ann M. Cresce at 3420 9049 or Mark Ho at 3420 9047.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Ann M. Cresce', written over a horizontal line.

Ann M. Cresce  
General Counsel and Head of Compliance

A handwritten signature in black ink, appearing to read 'Mark Ho', written over a horizontal line.

Mark Ho  
Chief Compliance Officer