中銀國際控股有限公司
BOC International Holdings Limited

Our Ref.: LCD12L0345

SFC
LICENSING DEPT
2012 SEP 11

Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

11 September 2012

Dear Sirs

Consultation paper on the regulation of electronic trading (the "Consultation")

1. We welcome the opportunity to comment on the Consultation. Our views on the Consultation are set out below. Abbreviates used in this letter have the same meaning as used in the Consultation.

Question 1: Do you agree that the proposed scope of the regulation of electronic trading is appropriate in terms of the types of electronic trading, which include internet trading, DMA and algorithmic trading?

2. We agree with the SFC to regulate electronic trading, including internet trading, DMA and algorithmic trading. This is in-line with international standard setting and to ensure market integrity. However, we strongly disagree with the SFC's proposal to ban an intermediary to offer DMA to clients if client orders are routed to exchange directly without going through the intermediary's infrastructure, the reasons for such are set out below.

<u>IOSCO report</u>

3. We believe the SFC drafted its regulations with reference to the final report "Principles of Direct Electronic Access to Markets" issued by the Technical Committee of the International Organization of Securities Commission ("IOSCO") in August 2010. IOSCO recognizes in the report the increasing use of electronic access and suggests principles to regulate electronic trading. Among others, Principle 6 - Markets states that "a market should not permit DEA[1] unless there are in place effective systems and controls reasonably designed to enable the management of risk with regard to fair and orderly trading including, in particular, automated pre-trade controls that enable intermediaries to implement appropriate trading limits"[2]. Based on this principle, we believe IOSCO focused on how intermediary exercises pre-trade controls, rather than the mode on how orders are being transmitted to market.

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[1] In IOSCO consultation report "Policies on Direct Electronic Access (Consultation Report)", Direct Electronic Access ("DEA") refers to the process by which a person transmits orders on their own (i.e., without any handling or re-entry by another person) directly into the market's trade matching system for execution. This definition should cover internet trading, DMA and algorithmic trading classified by the SFC

[2] 2 IOSCO Final Report on Principles of Direct Electronic Access to Markets (August 2012), page 20

香港花園道1號中銀大廈26樓
26th Floor, Bank of China Tower
1 Garden Road, Hong Kong
電話 Tel: (852) 2230 8888
傳真 Fax: (852) 2147 9065
Website: www.bocigroup.com

4. We note from the Consultation that the SFC proposes to ban intermediary to offer DMA that allows client orders to be routed to markets without going through intermediary's infrastructure with the reason that it considers this kind of arrangement limits the ability of an intermediary to monitor client orders and to implement effective risk control measures, including pre-trade controls. However, many DMA trading platforms currently available in the market are in fact able to conduct pre-trade controls even clients orders are not going through intermediary's infrastructure (we will elaborate this point further below). With these risk management tools, orders are scanned before they are released to the market. Therefore, we consider it is not necessary for the SFC to prohibit intermediary to offer DMA to clients even if client orders are routed to market directly without going through intermediary's infrastructure.

Pre-trade control

5. Some DMA trading platforms currently available in the market do not require intermediary to build its own trading infrastructure. Intermediaries are provided with risk/ credit management tools embedded with the trading platform to limit the firm's exposure. We would like to take "CQG", an order routing platform for ETD commodities products, as an example. CQG Inc. is a global leader in commodities futures industry offering access to real time data, analytical tools and order execution software. It is one of the 3 most widely used electronic platforms in the industry. Most of the world's major futures brokers offer CQG to their clients. CQG's execution software is Window-based. Clients of an intermediary could place orders via CQG software and orders will be routed by CQG's server to the designated exchanges directly.

6. CQG provides intermediary with a risk management tool, CQG CAST, that enables an intermediary to establish and implement automated pre-trade controls as described under paragraph 44 of the SFC consultation paper. Below are some of the commonly-used pre-trade risk control functions in CQG:

- Intermediary could set position limit by product types such as the number of contracts a clients could entered into according to the risk assessment performed by the intermediary;

- The number of contracts the client could enter into in any particular time would be checked against the cash balance available in client account before orders are released to market. "Negative open trade equity" is applied to all clients, meaning client can only trade up to cash balance minus open trade equity (i.e. if a client incurs unrealized loss, the client could only trade up to cash balance minus unrealized loss, while if the client has unrealized gain, it can only trade up to the cash balance);

- In order to limit the financial exposure of an intermediary, intermediary can enforce a "margin multiplier" for a risky client. A margin multiplier of 2 means margin would be doubled for the client;

香港花園道1號中銀大廈26樓
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- Intermediary could set a daily loss limit on client account where client is not able to enter addition transaction if they reach that daily loss limit;

- To prevent client enters potential erroneous orders, CQG allows user to pre-set order size, user will receive pop-up reminder if any order size exceeds the pre-set order size; on a second level of security, client order size is restricted by his account balance, trading size limit and position limit set by an intermediary;

- A "Reject Risky Market Order" options could be enabled such that client order will be rejected if prevailing market price is not available.

<u>Pre-vetting of customer</u>

7. The IOSCO report also suggests imposing pre-conditions for intermediaries to grant DMA to client. IOSCO Principle 1 - Minimum Customer Standard suggests intermediaries assess potential customers to ensure they meet minimum standard such as financial resources, basic knowledge of the market rules and proficiency in the use of the DMA system before granting DMA access right. The IOSCO report also reveals respondents to their consultation report in general use a vetting process to determine on a case by case basis which of their clients will be permitted to have DEA[3].

8. We believe pre-vetting is a far more effective measure to address risks posed by allowing a client to place orders outside of the intermediary's infrastructure. As quoted from the IOSCO report, "analysis of the Customer- is sometimes described by intermediaries as the most critical, since it is not possible to impose meaningful pre- and post-execution risk control measures unless the intermediary has a comprehensive understanding of the DEA Customer's risk profile"[4]. We agree that client who is offered with DMA should meet certain level of customer sophistication so as to ensure market integrity. We concur with SFC's suggestions to impose minimum client requirements for DMA service. By imposing minimum requirements on vetting clients, we can make sure clients who are provided with DMA understand market rules, and thus routing orders through an intermediary's infrastructure should not be a must.

<u>Intermediary's business strategy and size</u>

9. For client orders to be able to go through an intermediary's infrastructure, the latter must build its own hardware infrastructure. This would inevitably increase capital burden to small to medium size brokerage firms as they incur investment costs on setting up a commensurate infrastructure. Small to medium brokerage firms who could not afford to build its own infrastructure will eventually lose out to other larger players and we are concerned the SFC's

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[3] Final Report on Principles of Direct Electronic Access to Markets (August 2012), page 8
[4] Final Report on Principles of Direct Electronic Access to Markets (August 2012), page 13

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proposed requirement would create an unfair competition environment among all the industry players. Using BOCI as an example, most of our clients who trade global commodities and are offered with DMA (i.e. CQG execution software) are professionals or with a reasonably high level of sophistication. If for the aforementioned reason that we cannot offer DMA, we will lose these high quality clients, notwithstanding the risk profile of these clients are generally low, and pre-vetting of customer and pre-trade controls could be performed by using the risk management tools already embedded in the CQG trading platform. In the long run, high quality clients could simply trade with large foreign intermediaries or move their accounts to Singapore where there are plenty of brokerage houses offering commodities trading services. This is detrimental to the status of Hong Kong as an international financial centre and its plan to develop into a commodities trading hub in the Asia Pacific region.

Industry and market practice

10. As far as we are aware, some renowned international exchange companies, like the London Metal Exchange ("LME") and the Intercontinental Exchange ("ICE"), provide DMA trading platforms (LME Select by LME and WebICE by ICE) to their clearing members or member's clients to route orders to the respective exchanges directly using clearing members' identifier. These trading platforms also come with risk management tools. In fact, the use of third party DMA trading platforms is a common practice for global commodities trading as only big clearing banks have the scale to build and operate their own infrastructure on a cost effective basis.

Question 2: 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?

11. We strongly disagree an intermediary should be ultimately responsible for all orders sent to the market through its electronic trading system. This is because DMA would be offered to group companies or clients of an intermediary, who are also licensed or registered in Hong Kong or in an equivalent jurisdiction, and these licensed or registered persons may in turn offer access to the DMA to its underlying clients. The responsibility to perform pre-trade or post-trade controls should be the immediate client facing entity instead of the intermediary holding an exchange participant status who is merely routing trading orders to market for another licensed/registered person.

12. In addition to pre-trade and post-trade controls, we are of the view that clients who are licensed or registered persons and will offer DMA to its underlying customers should perform pre-vetting of its customers before granting them DMA to ensure market integrity.

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We respectfully request the SFC to consider our comments. Should the SFC wish to discuss any of our comments further or would like us to demonstrates pre-trade controls on CQG, please do not hesitate to contact our Jeannie Chung at 3988 6521.

Yours faithfully,

Calvin Wong
Managing Director
Head of Legal and Compliance Division

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