



28 September 2012

BY COURIER

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

Dear Sirs,

RE: Consultation paper on the regulation of electronic trading

Newedge appreciates the opportunity to provide our comment on the captioned Consultation Paper ("Consultation"). Newedge has been very active over the years, both in Asia and elsewhere, in working with regulators to develop rules and regulations designed to strengthen the financial markets. In particular to the regulation of electronic trading, Newedge has provided input to Committee of European Securities Regulators, European Securities and Markets Authority, Canadian Securities Administrators and International Organizations of Securities Commission. Given our size of business and operations, our broad experience across asset classes and regulatory regimes, we feel we are well positioned to provide such input and welcome the opportunity to do so.

Newedge, which is one of the world's largest brokerage organizations, offers its customers clearing and execution facilities across multiple asset classes including futures, securities (fixed income and equities), options, FX and various OTC instruments. Newedge maintains offices in over 15 countries, and is a member of over 85 exchanges worldwide. As of December 2011, Newedge had an estimated global market share in listed derivatives of 11% (clearing) and 12% (execution), and over Euro 40.5 billion of client assets on deposit. Newedge in HK consists of Newedge Group SA HK Branch, a registered institution regulated by the Hong Kong Monetary Authority and its licensed subsidiary companies, Newedge Financial Hong Kong Limited ("NFHKL") and Newedge Broker Hong Kong Limited ("NBHKL") regulated by the Securities and Futures Commission. NFHKL is a Trading Participant of HKFE / SEHK and a Clearing Participant of HKCC, SEOCH and HKSCC whilst NBHKL is a Trading Participant of HKFE and a Clearing Participant of HKCC and SEOCH. NFHKL continually is ranked as one of the top brokers on the HKFE in terms of execution and clearing volume.



Newedge welcomes SFC's Consultation and agrees with the Commission's aim of enhancing electronic trading rules to ensure market integrity and that such activity is conducted in a fair and orderly manner. In this letter, Newedge will express our opinions to the proposed regulations in the Consultation.

We want to highlight that electronic trading is an extremely broad and ever changing activity with various players and a diversity of arrangements. As a result, it is imperative that the proposed regulations should be practical and effective under the current market situation, but also flexible to account for future market and technological innovations. Further, while intermediaries have responsibilities for trades that pass through its systems, these responsibilities should take into account the various technological set-ups and practical / technical limitations facing intermediaries in the market today. It is Newedge's view that enhancing controls over electronic trading in the Hong Kong market is best achieved through a more balanced sharing of the roles and responsibilities among regulators, exchanges, intermediaries and where appropriate the investors and electronic trading service providers, as it is not practical for intermediaries alone to bare this responsibility.

For your ease of reference, our comments will follow the numbering of questions in the Consultation.

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, which include internet trading, DMA and algorithmic trading?

(ii) the types of products primarily covered by these proposals namely securities and futures contracts that are listed or traded on an exchange?

(iii) the persons to whom the proposals apply?

(i) The definition of electronic trading is overly broad. At the same time, the three components of electronic trading listed out in the Consultation are not precisely defined. We believe more precise and clear definitions of electronic trading and the three components can:

- help the market better understand the regulatory concerns of your Commission;



- let the market provide more relevant and focused comments to the standards; and
 - assist the Commission to formulate more clear and comprehensive standards.
- (ii) Agree to cover exchanged traded securities and futures contracts only;
- (iii) Based on our proposed sharing of roles and responsibilities among regulators, exchanges, intermediaries and where appropriate the investors and electronic trading services providers, it is beyond the scope of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. A more comprehensive regulatory regime that can apply to all the parties involved should be worked out.

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? If not, why not?

Newedge believes that an Intermediary has responsibility around its client orders for certain requirements where practically possible, the keywords being certain and practical.

Specifically, we believe that there are practical limitations for intermediaries to identify and prevent many improper trading by their clients. Limitations include: 1) the inability to know the intent of clients when placing orders, 2) technical limitations to monitor and control certain activities, especially for third party developed and controlled trading systems and 3) an intermediary does not have access to the overall picture in the market and its clients' activities sent through other intermediaries.

Even though some improper acts of the clients may be detected by intermediaries, it is unfair for the intermediaries to assume the regulatory risks arising from its client orders sent through the electronic trading system provided that they have reasonable controls in place. Without specifying the exact regulatory requirements to be monitored, it is unduly burdensome to the intermediaries and it may substantially increase the compliance cost of the intermediaries. The SFC should therefore limit and specify the exact applicable regulatory requirements that an intermediary needs to ensure compliance with for its client orders sent through the electronic trading system and then assess such compliance against the reasonableness of the intermediary's controls and procedures.



In doing so, the SFC should bear in mind the practicality and the cost efficiency of the control measures they expect to be instituted by the intermediaries. The SFC should also provide consideration that many third-party supplied electronic trading system may not provide all features to monitor the compliance with all applicable regulatory requirements and the intermediary being one of the licensed user of a third-party supplied electronic trading system may not have access to the system design and the ability to instruct the vendor to modify the system based on the local regulatory requirements in HK. Therefore, it is not justified to hold an intermediary responsible for client orders in compliant with the applicable regulatory requirements.

Above all, we strongly believe that the responsibility for client orders sent to the market through the electronic trading system should be allocated between intermediaries, exchanges and where practical investors and electronic trading service providers. Indeed, this approach has worked for some time in the US and Singapore. We recommend that:

- broad-based filters, blocks and controls should be implemented by the exchanges - such as those relating to circuit breaker, fat finger, away-from-the-market orders, trading halts, certain short restrictions, odd lots, market-on-close and limit-on-close restrictions, and
- client-specific filters, blocks and controls should be created by the exchanges and regulator and customized by the intermediaries - such as those relating to credit, order size and capital thresholds and limited regulatory compliance.

This two-tiered approach and shared responsibility between exchanges and intermediaries will yield important and pragmatic benefits.

First, establishing exchange level controls and providing intermediaries with common risk and compliance filters will help build a level playing field with respect to latency. If only intermediaries are allowed to develop their own controls, they may try to have the controls offering the lowest latency and will cause a "race to the bottom" that exposes the markets to more systemic risk.

Second, this approach will result in a more uniform system to allow both the exchanges and intermediaries better understand and comply with the relevant rules and allow SFC to enforce them more consistently and effectively.



Third, the implementation cost of these filters, blocks and controls can be evenly split between the intermediaries and the exchanges. The expenses involved for brokers in implementing such controls - to the extent they are solely responsible for creating and implementing them - will be significant and prohibitive.

Last but not the least, similar to the automated trading services providers, the SFC should consider to extend their supervisory power to the third-party electronic trading systems vendors through the licensing requirements and vetting of the design and controls of their systems offered to the market .

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? If yes, are the proposed requirements sufficient? If not, why not?

We agree in principal for systems proprietary developed by an intermediary. However, we want to highlight the practical difficulties encountered by the intermediaries to manage and supervise the design and development of the third-party supplied electronic trading system and the significant unlikelihood of third-party supplied electronic trading system vendors to disclose their system design and operation plan to the intermediaries as their users. In our opinion, it is beyond the control of intermediaries to extend their controls and liabilities to the design and development of third-party supplied electronic trading systems.

In addition, we do not find the benefit nor necessity to have at least one Responsible Officer or Executive Officer responsible for the overall management and supervision of the electronic trading because the current licensing regime already has RO or EO ultimately responsible for each businesses, operations or functions through the intermediaries' corporate governance, internal hierarchy, reporting lines, supervision and controls. The creation of an independent RO or EO responsible for electronic trading is not in line with the existing regime and also induces the necessity to have RO or EO designated to other businesses or operations.

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? If yes, are the proposed requirements sufficient? If not, why not?



SFC should provide further clarity on the definition of “material service interruption or significant issues” or by way of illustrative examples so that the market can be more familiar with the notification requirement. SFC could also avoid the number of unnecessary reports due to defensive notification.

We also express our concern over cost and benefit in the performance of stress testing on system capacity under different simulated market conditions. Mandatory testing in different simulated market conditions would be very costly and onerous if they need to cover every individual electronic trading system in use and every modification to these systems. We also cast doubt on the effectiveness of the stress testing results in term of the capacity projection as compared to actual market condition as well as the benefit of such testing to protect the market comparing to properly designed pre-trade controls on intermediary and exchange side.

We reiterate the shared responsibility between intermediaries and exchanges for the client orders sent to the market through the electronic trading system and this shared responsibility should extend to the effective controls to cancel unexecuted orders in the market so that both the intermediaries and exchanges can intervene with outstanding orders when necessary.

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?

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

Although we agree with the retention period of the record keeping and the scope of necessary records for audit logs and incident reports, with reference to Question 3, we raise a doubt on an intermediary’s ability to obtain design and development documentation from the third-party vendors. Furthermore, “comprehensive documentation” is too broad of a term and would need clearer explanation.

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?

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?

We refer to our comments made in Question 2 above. Newedge believes the cost, responsibilities and obligation associated with client orders sent to the market through the electronic trading system, including pre-trade controls and post-trade monitoring should be shared by the intermediaries and exchanges.

Automated pre-trade compliance and risk filters are important means of controlling the risk of internet trading and direct market access. Regulator should mandate certain specific minimum requirements that all intermediary and exchanges must follow, as opposed to merely requiring that they implement filters and controls reasonably designed. For details of the pre-trade filters and blocks to be implemented by the exchanges and the intermediaries, please refer to our comments per Question 2.

In addition, we also believe consideration should be made to review the exchange trading rules in respect of erroneous trades. This should not only be with the objective to further reduce the likelihood of such events, but to ensure there are clear rules in place to limit market disruption in case of such events.

Newedge agrees that post trade monitoring is an effective control measure to safeguard the integrity of the market and is also a means for intermediaries to report suspected breaches by clients of certain market misconduct, in accordance with its Code of Conduct requirement. Therefore, Newedge has committed significant resources to implement our trade surveillance system in order to promote and safeguard the market integrity. Our concern with the current SFC proposal is the lack of specificity around what is considered "manipulative or abusive" orders instructions or transactions. Specifically, we believe the identification of any suspected manipulative or abusive trading activities should be limited to the market misconduct or offences as defined in Part XIII or Part XIV of the SFO. The key point being misconduct or abusive practices should be the same for all trades and orders executed through an intermediary regardless as to whether such trades or executed electronically or through more traditional measures. Any proposed manipulative or abusive trading practices specific to electronic trading and above and beyond those prescribed in the SFO should be clarified and rigorously assessed with all market participants.

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?



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?

Direct market access customers should be required to meet certain financial and competency standards. However, the implementation of the client vetting process in relation to the client proficiency and competency in using the trading system, understanding on the applicable regulatory requirements and monitoring the orders, could become extremely burdensome and impractical if they are more than the contractual terms set out in the written agreement or client's declaration. As a result, we would propose that this condition be removed or significantly limited for Professional Investor Clients.

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 generally believe it is appropriate to have policies and procedures in place to ensure that the persons involved in design and development or approved to use the algorithmic trading system and trading algorithms are suitably qualified. We also refer to our comments per Question 3, where we cast doubt to the practicality of performing detailed due diligence, system testing, system review and system audit to a third party supplied algorithmic trading system and trading algorithms.

More importantly, we are interested to know whether SFC expects the person involved in the design and development of, or approved to use the algorithmic trading system and trading algorithms are required to register with SFC and be subject to SFC vetting process like the Automated Trading Services Provider. Ideally, all electronic trading system should be required to register with SFC or exchanges and pass a vetting process to ensure they comply with the exchange protocol and they can perform the necessary pre-trade controls as per regulation.

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?



Please refer to our comments to Question 4.

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?

Please refer to our comments to Question 7 and 8.

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?

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

Please refer to our comments to Question 5 and 6.

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?

Q17. 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?

We believe there needs to be more clarity on the detailed due diligence process that an intermediary would be expected to perform. However, we refer to our comments per Question 3, where we note that it does not seem practical or possible for intermediaries to independently verify that all of its third party supplied electronic trading systems are meeting all of the requirements as set out in this proposal.

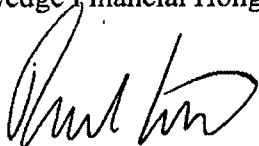
The Pulse of Finance

Newedge

We greatly appreciate SFC's efforts in soliciting the public's comments on these important regulations, and for all of its efforts to ensure the integrity of the market and the electronic trading in the market are conducted in a fair and orderly manner.

Thank you again for allowing us an opportunity to comment on the Consultation. If you have any questions regarding the matters discussed herein, please do not hesitate to contact Andy Law, Head of Compliance Hong Kong, at 3657 8683 or the undersigned at 3657 8087.

For and on behalf of
Newedge Financial Hong Kong Limited



Ronald Savino
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