

2012 SEP 25 PM 12: 12

24th September 2012

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

Dear Sir/Madam,

Comments in relation to the consultation paper on the regulation of electronic trading

In response to the captioned consultation published on 24th July 2012, we hereby submit our comments as below for your kind perusal:

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?**

We agree to include internet trading, DMA and algorithmic trading in the definition of electronic trading. However, we would like to seek the Commission's confirmation on the definition of algorithmic trading which shall be defined to only cover "computer generated trading activities created by a pre-determined set of rules aimed at delivering specific execution outcomes automatically and without human intervention".

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

Agree.

(iii) **the persons to whom the proposals apply?**

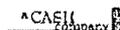
Agree.

Q2. Do you agree that an intermediary should be ultimately responsible for 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?

We agree that intermediary shall have appropriate and adequate internal control procedures to safeguard the operation of electronic trading. However, to make the intermediary ultimately responsible for all transactions sent through its electronic trading system imposes an undue onus on the intermediary. Although the Commission has, in the consultation paper, specifically

時富證券有限公司 Celestial Securities Limited

香港中環皇后大道中181號新紀元廣場低座21樓 總機 Tel: (852) 2287 8788 傳真 Fax: (852) 2287 8700
21/F, Low Block, Grand Millennium Plaza, 181 Queen's Road Central, Hong Kong

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excludes intermediary's liabilities against market misconduct or transgressions which the intermediary was not aware of when the trade was conducted, determining the intermediary's awareness on specific trades involves considerable subjective judgment and is rather arbitrary in nature. An ambiguous policy would definitely hamper the operation efficiency of the intermediary and distract resources of the intermediary which shall be put into better use in daily operation.

We urge the Commission to provide clear and specific requirements on internal control measures. Intermediary shall be obliged to comply strictly with such requirements. Those who failed to comply will face serious disciplinary actions. For market misconducts or transgressions occurring despite the control measures, intermediary shall be exempted.

We believe that the safeguard of market integrity shall be the joint responsibility of regulators, stock exchanges, intermediary, and other market participants. The imposition of the burden on intermediary alone would not help maintaining the efficiency and effectiveness of the preventive measures.

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 that intermediary shall effectively manage and supervise the deployment and operation of the electronic trading system it uses or provides to clients for use. Appropriate testing shall be carried out prior to putting the system into production and monitoring shall be performed regularly to detect irregularities.

However, information on the design and development of the system are generally proprietary to the third party system developer and would have been carried out long before the system is acquired by the intermediary. It would therefore not be practicable for intermediary to get involved in the design and development of the electronic trading system.

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?

We have particular concerns over the requirement to ensure system capacity. While we understand the importance of ensuring system capacity, we invite the Commission to provide more concrete specifications on the requirements, including the interval and the comprehensiveness of the testing.

Capacity test on individual capacity and on each and every changing market conditions would



impose huge costs to the intermediary.

On a cost-benefit perspective, such a huge cost could hardly be justified economically for each particular intermediary to conduct the capacity test on its own. It would hamper the development of electronic trading if no clear specifications are provided.

It is suggested that the HKEx should conduct large scale stress tests and capacity tests, and market rehearsals for all of its participants. It would be more realistic to simulate real market situation and effective to test the trading systems.

Q5. Do you agree that 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?

Please refer to our comment on Q3.

We agree that intermediary should keep records on the deployment and operation of the electronic trading system only. However, if electronic trading systems are provided by third party vendors, we believe that is infeasible for any intermediary to keep records on the design and development of the electronic trading system.

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

Please refer to our comment on Q5.

Q7. Do you agree that, in providing internet trading or DMA services, the proposed pre-trade controls should be put in place by intermediary? If yes, are the proposed requirements appropriate? If not, why not?

We generally agree that intermediary shall have appropriate pre-trades measures in place.

We would like to seek the Commission's clarification on the definition of "erroneous" and "disruptive" order instructions.

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 generally agree that intermediary shall have appropriate post-trades monitoring measures in place.



We would like to seek the Commission's clarification on the definition of "manipulative" and "abusive" trading activities.

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?

We agree that clients should meet certain requirements to be qualified to use DMA services. Of the few example provided by the Commission in the consultation paper, we would invite the Commission to provide more specific guidelines, perhaps to standardize and quantify the requirements such that intermediary could carry out the assessment more efficiently and objectively.

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?

Agree.

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 agree that intermediary should ensure that persons approved to use the algorithmic trading system and trading algorithms are suitably qualified.

We however invite the Commission to consider providing specific guidelines on required qualification, for example, minimum academic background and/or years of relevant working experience. Without any explicit minimum requirement, different intermediaries would employ their own standards for the qualification requirement and would nullify the intention of improving the quality of algorithmic trading professionals.

Moreover, we believe that intermediary shall not be held responsible for ensuring that the persons involved in the design and development are suitably qualified if the system is provided by third party vendor. This would be an onerous responsibility to the intermediary in view of the mere contractual relationship between itself and the vendor.

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 time? If not, why not?



We disagree with the Commission's proposal.

When the market is volatile, trading algorithms could possibly be subject to numerous amendments during the day. While we agree that the algorithmic trading system and trading algorithms shall be adequately tested before deployment, we do not believe it is realistic to require intermediary to ensure that the system operates as designed **at all time**. With changing market conditions and trading behaviors, trading algorithms could inevitably experience changes and it is possible that the resultant algorithms may differ from the algorithms as originally designed. It is also unjustified for intermediary to conduct testing during the period when the market opens.

Investor or algorithm trader would re-examine the risk profile of their investments from time to time to ensure that they suit their risk tolerance and expectations. Take hard look at what could go wrong with an investment, or the sort of ever-changing market conditions and other circumstances which could change suddenly, investor or algorithm trader would change their trading strategies anytime accordingly.

As an alternative, intermediary is obliged to perform periodic risk management according to the "Internal Control Guidelines" and Code of Conduct of the Commission. It should have sufficient risk management control measures in place, which operates at all times when market opens, to control risk exposure. For example, trading limit shall be closely monitored to control market impact and financial exposure.

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?

We would like to seek the Commission's clarification on the definition of "integrity" and the specific measures to take for ensuring integrity of the algorithmic trading system and trading algorithms.

While we agree that intermediary shall help to guard against market misconduct and operate their businesses in a way to foster compliance, we believe that the regulators should identify specific conducts, behaviors and actions which the intermediary should take to meet the objectives. The specific guidelines should be quantified and to be incorporated into the Securities and Futures Ordinance and Code of Conduct, of which intermediary are obliged to follow.



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?

Please refer to our comment on Q11.

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

Please refer to our comment on Q11.

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 paragraphs 18 of and Schedule 7 to the Code of Conduct in its uses of the system? If not, why not?

We disagree with the proposed requirement.

The burden of performing due diligence towards third party service provider should not be imposed on the intermediary. The relationship between the intermediary and third party vendors is based entirely on the committed contracts in which the vendors assume no obligations to assist the intermediary in complying with the Commission's requirements. When the vendors legitimately exercise their right to refuse rendering proprietary information required by the Commission, the intermediary then is forced either to risk committing a breach or to source some other vendors who are willing to release his or her own intellectual property. Such alternative vendors hardly exist.

Since third party vendor who provides algorithmic trading system could possibly impact the functioning of the market, the Commission may consider imposing appropriate monitoring and regulations on such third party vendors. The Commission may also consider including the provision of algorithmic trading system and trading algorithms as a regulated activity under a separate head who equips with relevant knowledge and experience. The Commission then could exert a more direct and effective control over the vendors.

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?

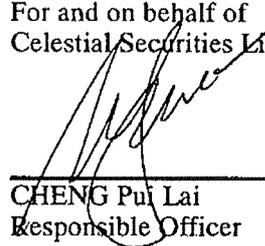
Please refer to our comment on Q16.

We believe that the Commission is in the best position to impose control and monitoring on third party service providers.



Should you have any further enquiries, please feel free to contact the undersigned at 2287 8800 or Ms. Connie Shum, Head of Compliance, at 2287 8490.

Yours faithfully,
For and on behalf of
Celestial Securities Limited



CHENG Pui Lai
Responsible Officer