Guardian

24th September, 2012

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

Re: Consultation Paper on the regulation of electronic trading

Dear Sir/Madam,

Consultation Paper on the Regulation of Electronic Trading – July 2012 ("the Consultation Paper")

As elucidated in the recommendations adopted in the Consultation Paper, we welcome the Commission's initiatives to regularise and control the electronic trading in the industry by reference to the Principles for Direct Electronic Access to Markets of the International Organization of Securities Commissions (the "IOSCO"). Whilst we support the overall objectives of the Consultation Paper, our major concerns and views over the proposal are stated below.

Question 1

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?**

In terms of types of electronic trading:

We agree that the definition of "electronic trading" is in line with the IOSCO Final Report on Principles for Direct Electronic Access to Markets ("IOSCO Final Report") and therefore, we have no further comment on it.

In terms of types of products covered:

The Consultation Paper proposed that the regulation of electronic trading should cover the leveraged foreign exchange trading. In our opinion, leveraged foreign exchange trading is deemed to be high-risk investment which is, however, accessible to all retail clients. Therefore, it is applauding to note that products of such kind have been covered in the regulation, so that more protection could be provided to retail clients. As a matter of fact, such protection may extend to other products exclusively for the professional investors in near future amid the increased online trading activities used by these investors.

In terms of the persons to whom the proposals apply:

Despite not being required in the IOSCO Final Report, in a slight divergence from other jurisdictions like Europe and Australia, the proposed rules extend risk protections on algorithmic trading to all internet trading provided to clients by brokers. Under the current regime of Hong Kong, brokers are one of those which have most daily dealings in relation to DMA. They deal with retail clients who place trading order and thus, they are expected to step up more stringent internal control. As such, we agree that brokers shall be included as "the persons to whom the proposals apply" for the purpose of the proposed rules.

Question 2

Do you agree 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?

We understand the Commission's regulatory intention to hold the intermediary ultimately responsible for the orders sent to the market through its electronic trading system irrespective of the party that initiates the orders and for the compliance of the orders with applicable regulatory requirements under this proposal. However, we take the view that to be fair to the intermediary, it shall be held responsible for the orders placed by the parties who initiate and the compliance of the orders with applicable regulatory requirements if any fault, (willful) negligence, mistake, omission and/or fraudery (whether intentionally, recklessly or unintentionally) are involved.

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Question 3

Do you agree that an intermediary should effectively manage and adequate supervise the design, development, deployment and operation of the electronic trading system it uses or provide to clients for use?

Yes, we agree and we have no further comments on this.

Question 4

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?

We suggest that it is more appropriate to leave the licensed corporations to decide the set-up of this off-site storage in view of their own business and operational needs/concerns.

Question 5

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?

Yes, we agree with this.

Question 6

Do you agree with the proposed periods of record keeping?

Yes, we agree. The proposed periods are in tandem with the statutory provision as contemplated in s.10 of the Securities and Futures (Keeping of Records) Rules (Cap. 571O).

Question 7

Do you agree that, in providing internet trading or DMA services, the proposed pre-trade controls should be put in place by an intermediary?

Although we also deem that it is the responsibility of the licensed corporations to prevent entry of any orders that may result in exceeding appropriate trading and credit thresholds prescribed, we are also of the opinion that the clients themselves must be well-informed and be aware of their own credit thresholds prescribed. Therefore, instead of placing the burden on the licensing corporations, the clients shall also be responsible for prevention of entries of such orders.

Question 8

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?

What constitute "transactions which may be manipulative or abusive in nature" are yet to be clarified. If such transactions amount to "market misconduct" as specified in Divisions 4 and 5 (SS.270-278) of Part XIII of the Securities and Futures Ordinance (Cap. 571)(the "SFO"), it is rather impossible for the licensed corporations to identify any irregularities of those "transactions which may be manipulative or abusive in nature". As such, the burden placed on the intermediaries is deemed too heavy and unreasonable.

Nonetheless, we are of the opinion that, if the transaction is found to be fraud in nature, the licensed corporations are obliged to report the same to the Commission for further investigation as soon as it becomes aware of it.

Question 9

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?

Although the IOSCO Final Report sets forth the principle of 'minimum customer standards' as one of the pre-conditions for DEA (Principle 1 in the IOSCO Final Report), the report is silent whether this is applicable to retail clients.

In Hong Kong, substantial percentage, if not majority, of DMA customers are retail customers. This accounts for the reason why brokers shall be included as "the persons to whom the proposals apply", as explained previously. In our opinion, lacking the resources, it is difficult for the licensed corporations to ensure the proficiency and competence of each and every of their clients, especially in the context of economic conditions. Therefore, we find it rather impracticable for the licensed corporations to satisfy this "minimum customer standard" requirement.

Question 10

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"?

Yes, we agree.

Question 11

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?

It may be difficult for the licensed corporations to ensure that the persons involved in the design and development of, or approved to use its algorithmic trading systems are "suitably qualified". Nonetheless, we agree that the licensed corporations should ensure the persons involved or approved to use the systems should have acquired reasonable level of knowledge and expertise in the relevant field.

Question 12

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?

We have no further comments on this.

Question 13

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?

Similar to our answer to Question 8 above, it remains unclear whether the "suspicious market manipulative or abusive activities" amount to "market misconduct" in ss.270-278 of the SFO. Therefore, if the terms are yet to be clearly defined, the burden to be placed on the licensed corporations appears to be too heavy.

Question 14

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 systems?

Yes, we agree with this.

Question 15

Do you agree with the proposed periods of record keeping and details of the records to be kept?

The proposed periods correspond with the statutory requirement pursuant to s.10 of the Securities and Futures (Keeping of Records) Rules (Cap. 571O). We have no further comments on the working details of these record keeping rules.

Question 16

Do you agree that where an electronic trading system is provided by third party 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?

We agree that the licensed corporations are obliged to make sure that it meets the proposed requirements. However, to be fair to the licensed corporations, in any event that there are any fault, (willful) negligence, mistake, omission and/or fraudery (whether intentionally, recklessly or unintentionally) on the part of the third party service provider, the latter shall be wholly and ultimately responsible therefor.

Question 17

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 agree that the licensed corporations may make such arrangements with their service provider. It is further recommended that as a matter of best practice and operational efficiency, the proposed record retention period is to be stated in the service agreement entered into between the licensed corporations and the service provider.

Should you have any questions pertinent to the foregoing, please feel free to contact the undersigned at 6088-0981 or chester_guardian@yahoo.com. Thank you very much.

Yours faithfully
For and on behalf of
Guardian Regulatory Consulting Limited

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