

MEMO# 26538

September 28, 2012

ICI Letter to Hong Kong SFC on Electronic Trading Consultation Paper

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 25-12
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 33-12
ETF ADVISORY COMMITTEE No. 34-12
INTERNATIONAL MEMBERS No. 40-12
SEC RULES MEMBERS No. 85-12 RE: ICI LETTER TO HONG KONG SFC ON ELECTRONIC TRADING CONSULTATION PAPER

The Hong Kong Securities and Futures Commission (“SFC”) published for comment a consultation on proposals to enhance the regulatory framework for electronic trading. [\[1\]](#) The proposals address general requirements for all forms of electronic trading including the responsibility for orders, management and supervision of systems, adequacy of systems and recordkeeping, as well as specific requirements related to testing of algorithmic trading systems and trading algorithms, user qualification and risk management controls. ICI filed a comment letter, jointly with ICI Global, on the consultation; a copy of the comment letter is attached and the most significant aspects of the letter are summarized below.

Scope of the Proposals

The letter strongly supports establishing principles and requirements for intermediaries regarding electronic trading, internet trading and direct market access, and algorithmic trading that address key issues such as systems capacity, testing, staffing, and recordkeeping. The letter states that given the proliferation of the types of electronic trading and the presence of electronic trading across all types of asset classes, the scope of the regulation of electronic trading should be broad with respect to the types of electronic trading and products covered by the proposals. In addition, the focus of the consultation should be on intermediaries and on the regulatory requirements for intermediaries to manage and mitigate the risks that arise from using or providing an electronic trading system and from trading in an electronic trading environment overall.

The letter notes, however, that the consultation proposes that the principles and requirements be incorporated into the SFC Fund Manager Code of Conduct. Funds, therefore, would be subject to the majority of the proposed principles and requirements in

their trading as funds often would be conducting “electronic trading” as defined in the proposal. The letter states that, as proposed, it is unclear how fund managers would comply with many of the principles and requirements due to the nature in which funds trade and use electronic trading systems, as well as the nature of the relationships between funds and intermediaries. The letter therefore recommends that the SFC clarify the specific provisions in the proposal that would apply to fund managers, the scope of those provisions, and how fund managers would comply with such provisions.

Requirements on Electronic Trading, Internet Trading and DMA, and Algorithmic Trading

The letter states that an intermediary should have the ultimate responsibility for orders sent to the market through its electronic trading system and for the compliance of orders with applicable regulatory requirements. The letter therefore supports proposed measures that would require an intermediary to ensure the integrity of its electronic trading system as well as proposed requirements for an intermediary to ensure that the electronic trading system and all modifications to the system are adequately tested before deployment and are regularly reviewed to ensure that the system and modifications are reliable. In addition, the letter strongly supports requiring an intermediary to employ adequate security controls to protect the electronic trading system it uses or provides to clients from being abused including, among other things, effective techniques to protect the confidentiality and integrity of information stored in the system and passed between internal and external networks.

The letter also supports subjecting algorithms to appropriate rules and controls, such as requirements for policies and procedures aimed at preventing algorithms from operating in an unintended manner. Specifically, the letter supports draft guidelines related to the use of clearly delineated development and testing methodologies to seek to ensure that, among other things, the operation of trading algorithms is compatible with an intermediary’s obligations under relevant regulations, that the compliance and risk management controls embedded in the algorithm work as intended, and that the algorithm can continue to work effectively in stressed market conditions. The letter also states that it is reasonable that persons involved in the design and development of, or approved to use, an intermediary’s algorithmic trading system and trading algorithms are suitably qualified.

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[Attachment](#)

endnotes

[1] The consultation can be found on the SFC’s website at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP3>.

should not be considered a substitute for, legal advice.