CLIFFORD

CHANCE

Briefing note

26 July 2012

Consultation on new regulatory framework for electronic trading

Introduction

On 24 July 2012, the SFC published a consultation paper commencing a two month consultation on a proposed regulatory framework for electronic trading, including internet trading, direct market access (DMA) and algorithmic trading.

Electronic trading has been under active scrutiny by the SFC for some time. The regulatory focus is typically on whether there are sufficient controls and safeguards around the trading systems to prevent market manipulation or the creation of a disorderly market. In the case of DMA or internet broking, the concern is whether there are sufficient safeguards to prevent a client using an intermediary's infrastructure and market access for an abusive purpose. In the case of high-frequency and algorithmic trading, the regulatory enquiry is often whether there are sufficient safeguards to prevent market disorder or distortion as can occur, for example, when a high-volume of trades executed through an algorithm are not responsive to a lack of liquidity in target shares.

Key issues

- Accountability for electronic trades
- Management responsibility
- Pre and post-trade controls
- Documentation
- Reporting to the SFC
- Implementation

The SFC's proposals reflect these focus areas. The requirements are prescriptive, specific and are centred on systems and controls. The specific proposals are summarised below.

The proposed changes will apply to any licensed intermediary that electronically trades listed securities or futures through automated systems, whether for its clients or on its own account. This includes fund managers who conduct electronic trading for collective investment schemes which they manage. Electronic trading is defined as "the trading of securities and futures contracts electronically, and includes internet trading, DMA and algorithmic trading". The definition is broad and therefore potentially unclear but, the apparent intention is that these additional controls apply where orders are processed through automated systems without significant human intervention.

The consultation closes on 24 September 2012.

Overview and potential impact of the proposals

The proposals are detailed and prescriptive. Key themes include:-

- **Accountability for electronic trades.** A proposed addition to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission will explicitly hold intermediaries responsible for orders placed through their electronic trading systems, including client orders. The Consultation Paper acknowledges that this does not mean that intermediaries will automatically be held liable for market misconduct or other transgressions resulting from client orders. However, such trades would lead, at least, to scrutiny of whether the proposed requirements such as pre-trade controls and post-trade monitoring were in place and operating effectively. In effect, the intermediary would need positively to demonstrate that it had done everything it reasonably could to prevent such trades.

- **Management responsibility.** The SFC and the HKMA have made increasingly clear their intention to hold management, including Responsible Officers and Executive Officers, responsible for material control failures in the business areas that they supervise. This general theme is now a feature of new regulation on specific issues, for example the present consultation on new requirements for IPO sponsors. The requirement that there be at least one executive officer or responsible officer with designated responsibility for overall management and supervision of any electronic trading system reinforces this. If these proposals are implemented, it will be important for the associated executive or responsible officers to oversee and be closely involved in implementation and ongoing compliance.

- **Pre and post-trade controls.** The requirements for pre-trade controls and ongoing post-trade monitoring designed to prevent and/or detect erroneous or potentially abusive or disorderly trades are central to the proposals.

- **Documentation.** There are explicit and detailed documentation requirements regarding the design, development, ongoing operation and risk management of electronic trading systems, together with ongoing audit logs and incident reports. This evidences a clear regulatory intent to require a detailed audit trail to check the ongoing operation and facilitate the investigation of electronic trading systems.

- **Reporting to the SFC.** The requirement to regularly conduct post-trade monitoring sufficient to reasonably identify potentially manipulative or abusive trades should be considered in light of the existing obligation promptly to self-report any actual or suspected legal or regulatory breach and, from 1 December 2012, the incoming obligation to report to the SFC any suspected market misconduct by a client. The proposals also contain a stand-alone obligation promptly to report to the SFC any material interruptions or significant systemic issues with an electronic trading system. Please click here to view our previous client briefing on the expanded reporting obligations under the Code of Conduct.

- **Implementation.** The Consultation Paper does not provide any transitional time-frame for implementation if all or some of the proposals are adopted. However, the proposals are potentially onerous in terms of required documentation, systems and governance and, depending on the existing framework, may require significant resource and oversight for implementation.

The proposed new requirements are listed in the attached Appendix.

Contacts

Martin Rogers

T: +852 2826 2437

E: martin.rogers@cliffordchance.com

Paget Dare-Bryan

T: +852 2826 2459

E: paget.darebryan@cliffordchance.com

Donna Wacker

T: +852 2826 3478

E: donna.wacker@cliffordchance.com

Lisa Chen

T: +852 2826 2438

E: lisa.chen@cliffordchance.com

Mark Shipman

T: +852 2825 8992

E: mark.shipman@cliffordchance.com

Matt Feldmann

T: +852 2825 8859

E: matthias.feldmann@cliffordchance.com

James Wadham

T: +852 2825 8837

E: james.wadham@cliffordchance.com

APPENDIX

Proposed amendments to the Code of Conduct

The proposed amendments are in two parts. First, the addition of a new paragraph 18 to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission which contains general principles. Second, the addition of a new Schedule 7 to the Code containing specific requirements underlying those principles. Read together, these comprise requirements applicable to all electronic trading systems and requirements specific to DMA, Internet Trading and/or Algorithmic Trading.

It is also intended to make minor changes to the Fund Manager Code of Conduct, stating that certain of these requirements apply also to fund managers who conduct electronic trading on behalf of collective investment schemes which they manage, and to Schedule 6 of the Code of Conduct to apply the requirements to the trading of leveraged foreign exchange contracts by means of internet trading.

The proposals are as follows:-

All Electronic Trading

- **Responsibility for orders.** Intermediaries will be held ultimately responsible for orders sent to the market through their electronic trading systems and for the compliance of those orders with applicable regulatory requirements, irrespective of whether a client or third party initiates the order.

- **Management and supervision**:
  - Written policies and procedures must be established and implemented for the <u>operation</u> of electronic trading systems to ensure that there is: (1) at least one executive officer or responsible officer with designated responsibility for overall management and supervision; (2) a formalised governance process with appropriate functional input from dealers, risk and compliance; (3) clearly identified reporting lines; and (4) managerial and supervisory controls designed to manage risks arising from the use of electronic trading systems.
  - The same obligations also apply to <u>design, development</u> and <u>deployment</u> of the electronic trading system made available for use by clients (Note: the draft Schedule 7 indicates that the obligations only apply to design, development and deployment of an electronic trading system made available to clients, but this distinction is not apparent from the SFC's covering commentary).
  - Regular reviews must be conducted to ensure that these policies are updated and in line with changing market conditions.
  - Adequately qualified staff and resources should be allocated to design, development, deployment and operation.

- **System adequacy:** Specific requirements are proposed around:
  - Controls - these should allow the immediate prevention of orders, and the cancellation of unexecuted orders, if they are found to be erroneous or potentially disruptive or abusive;
  - Reliability – systems (and modifications) should be tested before deployment and regularly thereafter. Material interruptions or significant system issues should promptly be **reported** to the SFC;
  - Security – to prevent abuse or misuse of trading systems;
  - Capacity – this should be regularly monitored and stress tested, and a written contingency plan implemented including back-up arrangements and a suitable backup facility.

- **Record keeping:** Proper records must be created and retained on the design, development, deployment and operation of electronic trading systems including:-
  - Comprehensive documentation of design and development, including testing, reviews, upgrades and modifications – to be retained for at least two years after the system has ceased to be used;
  - Comprehensive documentation of risk management controls – to be retained for at least two years after the system has ceased to be used;
  - Audit Logs – meeting the detailed minimum requirements set out in the Annex to the proposed new Schedule 7 (to be retained for at least two years); and
  - Incident Reports for any system delay or failure – also meeting the detailed minimum requirements set out in the Annex to the proposed new Schedule 7 (to be retained for at least two years)

DMA

- **Minimum client requirements** must be established, and an initial and ongoing assessment made as to whether clients meet these requirements before being allowed to use, or continue to use, DMA services. This includes obtaining satisfaction that the client understands and can comply with applicable regulatory requirements and that the client has appropriate arrangements in place to ensure that its representatives can competently use the DMA service.

- **Delegation of DMA access.** Only clients who are themselves licensed or registered persons, or an overseas securities or futures dealer, can be permitted to sub-delegate the DMA service to another person, and there must in those circumstances be arrangements in place to ensure that minimum client and risk management and supervisory requirements will be met.

- **Orders must be placed through an intermediary's infrastructure.** Arrangements to allow clients to place orders using an intermediary's identifier without going through that intermediary's infrastructure will be prohibited.

DMA and Internet Trading

- **Risk management and supervisory** controls must be established for internet trading and DMA services. This includes ensuring that all orders are transmitted to the trading infrastructure and are made subject to:
  - (a) automated pre-trade controls reasonably designed to: prevent the acceptance of orders exceeding trading and credit thresholds; identify and alert potentially erroneous orders; prevent orders that are not compliant with regulatory requirements; and limit the financial exposure of the intermediary.
  - (b) post-trade monitoring to reasonably identify instructions and transactions that may be manipulative or abusive

Algorithmic Trading

- **Qualification requirements:** Policies should be established and implemented to ensure that persons involved in the design and development, or approved to use, algorithmic trading systems are suitably qualified and trained. Traders who use the system should understand the relevant compliance and regulatory issues, and should be provided with an up-to-date user manual.

- **Testing.** Trading algorithms and algorithmic trading systems, including subsequent developments and modifications, should be adequately tested before deployment and on a regular (at least annual) basis to ensure that they will:-
  - operate as designed;

  - take into account extreme market circumstances and different trading sessions (such as auction and continuous trading sessions); and
  - not interfere with an orderly and fair market.

- **Risk management**. Effective controls must be implemented to ensure that trading algorithms and systems operate in the interest of market integrity by monitoring and preventing erroneous, abusive or disorderly trades. Post-trade reviews should be conducted regularly to identify such trades and, if identified, immediate steps should be taken to prevent recurrence.

- **Record keeping**. A "complete audit trail" should be documented and retained of the design and development (including modifications) of any algorithmic trading system and trading algorithms. This should record the rationale and intended outcome of the design and development. It should be retained until at least two years after the system and/or algorithms cease to be used. Records of parameters used for each order, and of reviews and tests, must also be retained for at least two years.

- **Third party algorithms and systems**. The above requirements will apply irrespective of whether the system or algorithm is designed and developed in-house or by a third party service provider.

Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong