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SFC Fines IBHK concerning Electronic and Algorithmic Trading Systems

Hong Kong's Securities and Futures Commission (**SFC**) has publicly reprimanded and fined Interactive Brokers Hong Kong Limited (**IBHK**) HK$4.5 million for breaches of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) which lead to two incidents of market disruption which saw the share prices of two Hong Kong- listed companies doubled within minutes. The SFC's statement of disciplinary action details deficiencies in IBHK's execution of market orders using electronic and algorithmic trading systems.

Summary of facts

On 23 October, 2015, the share price of O-Net Communications (Group) Limited (stock code: 877) rose 48.7% from $1.97 to $2.93 for 101 seconds when IBHK was executing a market order for a client to buy 500,000 shares. A second incident occurred on 12 July 2016 when the share price of AAG Energy Holdings Limited (stock code: 2686) rose 126% in 84 seconds when IBHK executed a market order for a client to buy 200,000 shares.

Market orders, according to the SFC, should be executed immediately at the best available price. The Stock Exchange of Hong Kong does not accept such orders during the continuous trading session. Instead, licensed corporations may use the enhanced limit order or the special limit order to simulate a market order.

An enhanced limit order is similar to limit order except that it will allow matching of up to ten price queues at a time. The bid order price of an enhanced limit order can be inputted at nine spreads higher than the current ask price. Unfilled quantity of an enhanced limit order will not be cancelled but stored as a limit order at the input order price. A special limit order has no restriction on the order price and will match up to ten price queues as long as the traded price is not worse than the order price. The unfilled amount of a special limit order will not be stored and will be cancelled.

The SFC stated that executing market orders through an algorithmic trading system that does not have reasonably designed controls may cause fluctuations in share prices and result in undue market impact. The SFC gives the following examples of how undue market impact can be controlled:

(a) limiting the number of attempts in resubmitting the unexecuted quantities of a market order for matching in the market; or

(b) restricting the execution of market orders to a maximum number of spreads from the prevailing nominal price.

Any unfilled quantity of the market order will be cancelled after the predetermined number of attempts or the maximum number of spreads is reached.

Summary of regulatory requirements

A joint independent review of IBHK's electronic and algorithmic trading systems found that IBHK had executed market orders by placing the entire order volume to the market and repeatedly submitting the unexecuted part of the order at the next available price until the entire order was complete in both instances. The review also found that IBHK did not take into account the liquidity of the market when executing the market orders. Furthermore, IBHK failed to put in place effective price and volume controls to prevent its execution of market orders from disrupting the market. In light of the independent review, the SFC found that IBHK failed to comply with paragraph 3.3.1 of Schedule 7 to the Code of Conduct which states that a licensed or registered person should have controls that are reasonably designed to:

1. monitor and prevent the generation of or passing to the market for execution order instructions from its algorithmic trading system which may be erroneous; or interfere with the operation of a fair and orderly market; and
2. protect the licensed or registered person and its clients from being exposed to excessive financial risk.

Factors considered in determining the appropriate disciplinary action

In considering the appropriate disciplinary action, the SFC took into account that IBHK breached paragraph 3.2 of Schedule 7 to the Code of Conduct when it failed to ensure that the algorithmic trading system it uses or provides to its clients for use are adequately tested to ensure that they operate as designed. IBHK also failed to keep, or cause to be kept, proper records on the design, development, deployment and operation of its electronic trading system in breach of paragraphs 1.3 and 3.4 of Schedule 7 to the Code of Conduct.

On the other hand, the SFC took into account that IBHK had involved their senior management in their liaison with the SFC about the regulatory concerns; took the initiative to bring this matter to a conclusion by entering fully into discussions about the regulatory concerns with the SFC; undertook a review with the SFC to address the regulatory concerns and identify the deficiencies in its internal controls; and co-operated with the disciplinary action by resolving the SFC's regulatory concerns. In balancing these issues, the SFC decided to publicly reprimand and fine IBHK $4.5 million pursuant to section 194 of the Securities and Futures Ordinance. The SFC stated that it had considered that IBHK's board of directors had undertaken reasonable steps in ensuring IBHK's compliance with regulatory requirements for electronic and algorithmic trading, and the failures set out above will be rectified within 12 months. The SFC warned that IBHK would otherwise have been subjected to a substantially higher level of fine.

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Hong Kong Office
Dominion Centre
12th Floor
43-59 Queen's Road East
Hong Kong
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596

www.charltonslaw.com