

## Press Release

### LCQ12: Regulation of dark pool trading

Wednesday, March 3, 2010

Following is a question by the Hon Mrs Regina Ip and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (March 3):

Question:

It has been reported that Singapore Exchange and an international electronic stock trading centre has jointly set up a "dark pool" trading platform for institutional investors to conduct block trading of stocks listed in the Asia-Pacific region, including Australia, Hong Kong and Japan, by way of offshore trading. Regarding the development of "dark pool" trading in Hong Kong, will the Government inform this Council:

- (a) whether it knows the average turnover of Hong Kong stocks (HK stocks) transacted on "dark pool" trading platforms in Hong Kong in each of the past 12 months, as well as the respective percentages in the total turnover of HK stocks;
- (b) whether trading activities on "dark pool" trading platforms are currently monitored by the Securities and Futures Commission (SFC) under the Securities and Futures Ordinance (Cap. 571); whether it knows if operators of "dark pool" trading platforms are required to apply to SFC for the relevant licences; if so, of the necessary application requirements, approval procedure and scope of monitoring by SFC;
- (c) given that "dark pool" is a platform for matching anonymous block orders of stocks between buyers and sellers and such transactions are made mainly by institutional investors, whether it has assessed the unfair situation caused by "dark pool" trading to ordinary investors; if it has, of the details; if not, the reasons for that;
- (d) given that it has been reported that the United States passed a bill in October last year to strengthen the monitoring of "dark pool" trading and enhance the transparency in the trading of financial products, whether the authorities will follow the practice of

the United States and review the relevant monitoring mechanism, so as to regulate "dark pool" trading activities;

(e) given that it has been reported that some operators of "dark pool" trading have indicated that the turnover of HK stocks transacted on their trading platforms might reach 5% to 10% of the total turnover of HK stocks, thus directly affecting the turnover of stocks transacted through the Hong Kong Exchanges and Clearing Limited (HKEx) in Hong Kong, of the counter-measures put in place by the authorities and whether it knows those by HKEx; and

(f) whether it has assessed the merits and demerits of developing alternative trading (such as "dark pool" trading) platforms for Hong Kong to maintain its position as an international financial centre in the long run; if it has, of the details; if not, the reasons for that?

Reply:

President,

"Dark pool" is a major category of alternative trading venues, which are facilities that allow securities transactions to take place outside traditional exchanges. As implied by the name, dark pools are opaque due to the lack of pre-trade transparency (i.e. bid/ask prices and the identity of the parties quoting those prices are not displayed) and post-trade transparency (i.e. the details of executed trades are not disclosed to the public). This is to cater for the need of institutional investors and others that seek to execute large trading interest in a manner that will minimise impact to market price.

My replies to the sub-questions are as follows –

(a) Currently there are ten dark pools operating in Hong Kong offering trading of Hong Kong securities. They are mainly brokers/banks' internal crossing engine whereby their customers' orders would be channelled to the internal pool for matching (i.e. internalisation) before they are routed to the exchange market. It is estimated that transactions executed in these dark pools represent less than 3% of the total market turnover.

(b) The brokers/banks which operate internalisation pools in Hong Kong have

obtained a Type 1 (dealing in securities) and Type 7 (providing automated trading services) licence from SFC under Part V of the Securities and Futures Ordinance (SFO).

The requirements which have to be met by applicants are stipulated in the SFO and elaborated in SFC's Fit and Proper Guidelines. In summary, the applicant must –

(i) be a corporation;

(ii) satisfy SFC that it is fit and proper to be licensed, has an appropriate organisational structure, good internal control systems and suitably qualified personnel to enable it to meet its regulatory obligations, and appropriate infrastructure and internal control systems to effectively manage risks, avoid conflict of interest and create proper audit trails;

(iii) have at least two responsible officers to directly supervise the conduct of each regulated activity;

(iv) have substantial shareholders whose status as such would not impugn its fitness and propriety to be, and to remain, licensed; and

(v) satisfy the prescribed financial and solvency requirements.

(c) Dark pools operated by brokers/banks currently account for only a small percentage of market turnover. At this stage, there has not been any adverse implication for retail investors in terms of fair access.

(d) We understand that no new regulatory requirements have been introduced in the United States (US) or Europe yet. The US Securities and Exchange Commission has just completed the public consultation on its proposals intending to enhance transparency of dark pools. The European Commission has initiated a review of the regulation of dark pools in its overall review of the implementation of the Markets in Financial Instruments Directive. The International Organisation of Securities Commission has also commenced a new project to examine potential regulatory issues in view of the proliferation of dark pools. SFC is a member of this project team. Together with SFC, we are monitoring the global developments and review our own regulations as appropriate.

(e) Currently all transactions in Hong Kong stocks by SFC-licensed automated trading services providers are reported to HKEx. SFC and HKEx would continue to monitor the development of dark pools locally and in the region.

(f) In general, dark pools are not a new phenomenon. Market participants that need to trade in large size, such as institutional investors, always seek ways to minimise their transaction costs by completing their trades without prematurely revealing the full extent of their trading interest to the broader market. Dark pools have the benefit of bringing down trading costs, improving efficiency of trade execution and providing significant innovation in terms of trading services offered. On the other hand, we note that the emergence of dark pools has raised concerns over the lack of transparency which could create a two-tiered market that deprives the public of information about stock prices and liquidity. Together with SFC, we are monitoring the development of dark pools in Hong Kong and other major markets. We would consider and take any necessary measures to ensure that the markets function in an orderly and fair manner.

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