Press release

LCQ15: Regulation of dark pool trading

Wednesday, November 28, 2012

Following is a question by the Hon Kenneth Leung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 28):

Question:

The use of dark liquidity for the trading of equities and the development of so-called dark pools and dark orders has increased as a result of greater efficiency in handling dark pool trading achieved through the use of new technology. Dark pools, as alternative trading platforms to public securities exchanges, allow financial institutions to trade large volume of shares, away from the eyes of the public, in anonymity and with lower trading fees. To increase the post-trade transparency of Hong Kong-listed securities executed in dark pools, The Stock Exchange of Hong Kong Limited introduced on February 1, 2011 a voluntary flagging requirement. According to the statistics of the Securities and Futures Commission of Hong Kong (SFC), trades executed in dark pools accounted for about 1.5% of the total turnover on the Hong Kong securities market from February 2011 to February 2012. In response to the growth in electronic trading activities, SFC issued a "Consultation paper on the regulation of electronic trading" in July 2012 for public consultation. In this connection, will the Government inform this Council:

(a) if it has taken an official stance on whether dark pool trading should be prohibited, regulated, or encouraged; if it has, of the details;

(b) whether it knows when SFC will release the outcome and conclusions of the aforesaid consultation exercise; and

(c) whether the authorities will consider introducing legislation to regulate dark pool trading with a view to increasing its transparency, preserving the integrity of the local stock market and giving better protection to retail investors; if they will, of the legislative timetable, and whether they will conduct a separate public consultation on the proposed legislation?

Reply:

President,

My reply to the Member's question is as follows:

(a) and (c) Dark liquidity exists as market participants seek ways to execute their trades faster at better execution prices and to minimise market impact especially for large orders. In recent years, the handling of dark liquidity has been made more efficient at the advent of new technology. This has promoted the growth in electronic trading venues that do not provide any pre-trade transparency regarding the orders that are received by or reside in the trading venues. Such trading venues are known as dark pools.

Dark pool trading in Asia (including Hong Kong) is small compared with that in the US and Europe. For example, the reported volume of trades executed in dark pools in Hong Kong accounted for about 2.2% of total market turnover as at end October 2012.

Under our regulatory system, dark pool operators are required to apply to the Securities and Futures Commission (SFC) for licences under Part V of the Securities and Futures Ordinance (SFO). The licences of dark pool operators are generally subject to a series of licensing conditions and their conduct is subject to on-going supervision by SFC. Moreover, like other licensees under the SFO, dark pool operators are required to comply with the provisions of the SFO and subsidiary legislation as well as other instruments made under the SFO, such as the Code of Conduct for Persons Licensed By or Registered with SFC.

To better monitor dark pool activities in Hong Kong, the Stock Exchange of Hong Kong (SEHK) introduced a voluntary reporting requirement on February 1, 2011 such that exchange participants are required to flag all dark pool transactions in Hong Kong stocks as "ALP" (Alternative Liquidity Pool) when they report such transactions to SEHK. Since October 3, 2012, SEHK has mandated such reporting requirement in its Rules.

We note that regulators in the US and Europe as well as the international regulatory bodies such as the International Organisation of Securities Commissions have been keeping a close watch on the development of dark pools. Together with the regulators, we will continue to monitor these international developments to ensure that Hong Kong's regulatory regime is on par with international standards.

(b) In recent years, technological developments have led to the proliferation of automated electronic trading. Specifically, similar to other major markets, there is an increased use of arrangements that are commonly described as direct market access, as well as the use of complex trading algorithms in the conduct of trades and the implementation of trading strategies. As trading becomes an almost instantaneous process without significant human intervention, corresponding effort is required to ensure that trading via direct market access or by the use of trading algorithms are conducted in a fair and orderly manner so as to maintain integrity of the market.

In this connection, SFC issued a "Consultation Paper on the Regulation of Electronic Trading" in July 2012, setting out proposals on the regulatory requirements for intermediaries to manage and mitigate the risks arising from trading in an automated environment. The proposals aim to provide a more coherent and comprehensive set of regulatory framework for electronic trading. They apply to licensed or registered persons who place orders to the markets electronically, including via the internet or by trading algorithms, for the trading of securities and futures contracts that are listed or traded on an exchange. The proposals of the consultation paper do not apply to dark pool operators or dark pools as trading platforms.

The public consultation has ended in September 2012. SFC is considering the submissions made in response to the above consultation paper and will publish the consultation conclusions in due course.

Ends