

Hong Kong Futures Exchange Ltd.
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ROBERT B "RANDY" GILMORE
Chief Executive

COMMENT

1998 SEP 21 12 40 PM '98

**HONGKONG
FUTURES**

September 17, 1998

Ms. Jean A. Webb
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMODITY FUTURES
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Dear Ms. Webb,

Re: Foreign Board of Trade Terminals

The Hong Kong Futures Exchange Limited (the "HKFE") appreciates this opportunity to comment on the Concept Release (the "Release") of the Commodity Futures Trading Commission (the "Commission") regarding placement at locations within the United States of computer terminals through which orders can be transmitted for execution on the electronic market system of a foreign board of trade (63 *Federal Register* 39779 (July 24, 1998)).

About the HKFE

Established in 1976, the HKFE is a derivatives market leader in the Asia Pacific region. The HKFE provides efficient and diversified markets for the trading of futures and options contracts by its more than 130 member organizations, including many that are affiliated with international financial institutions.

The HKFE operates futures and options markets on a broad range of products including equity index (e.g., Hang Seng Index futures and options and Hang Seng China-Affiliated Corporations Index futures and options), stock, interest rate (in particular, HIBOR futures) and foreign exchange products. At present, other than futures and options based on the Hang Seng Index or the Hang Seng Sub-indices which are traded on HKFE's trading floor via open outcry, all other products of HKFE are traded electronically on its Automated Trading System (ATS).

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Under the ATS system, the HKFE operates the central marketplace and subscribing members can directly access the market through computer terminals located in their respective offices. Only authorized users are allowed access to the ATS. An authorized user must be a person who is nominated by an HKFE Member and approved by HKFE; who is a registered Member Representative or Staff; and who has passed all tests so required by the HKFE. The principle underlying the ranking of orders entered into and accepted by the ATS involves the application of a strict price/time priority methodology. Plans are being implemented to convert HKFE's marketplace to a fully electronic order matching system some time during 1999.

The HKFE, with its subsidiary HKFE Clearing Corporation Limited (HKCC), operates a rigorous risk management system, enabling members and their clients to meet their respective investment and hedging needs in a liquid and well regulated marketplace.

Both the HKFE and HKCC are subject to regulatory supervision by the Hong Kong Securities and Futures Commission, which in turn, is accountable to the Hong Kong Government for the discharge of its responsibilities. As self-regulatory organizations, the HKFE and HKCC have also established rules, regulations, procedures and guidelines to regulate and monitor their respective members, including their trading practices, financial conditions and dealings with clients.

Summary of HKFE Comments

The HKFE believes that the Release may have a greater potential impact on the international exchange community than any proposal that the agency's has ever made. A trend toward electronic trading is manifest throughout the world and is even taking cautious root on U.S. boards of trade. To invoke these technological developments as justification for greater Commission regulation of foreign markets is a mistake. In brief, the HKFE's views are as follows:

1. Trading terminals are merely state-of-the-art *communications devices*; they do not (and cannot) carry out the execution of a transaction. They should be viewed no differently from a telephone which can be used presently to convey the same information to the execution facility without special regulatory constraints.

2. HKFE urges *against* any change in Commission policy based on evolving electronic trading techniques. The Commission's regulatory objective of assuring that its program is carried out in that (or any other) environment is fully accomplished by requiring trading terminals to be under the control of a registered futures commission merchant and to be operated only by a registered associated person.
3. HKFE also urges *against* treating as domestic "contract markets" foreign boards of trade that derive substantial trading volume from U.S. sources. In most cases such success is the result of innovation, effective marketing and aggressive competition that a volume "quota" would stifle.
4. HKFE expresses *support* for (a) allowing trading terminals to be located in the offices of bona fide affiliates of an exchange's member firms; (b) allowing trading terminals to be located in the floor booths of member firms or their affiliates on the U.S. contract markets; and (c) application of a principle of "reciprocity" to assure that placement policy becomes consistent across nations.

Detailed Comments on the Release

A. Linking Regulatory Policy to Technology

An underlying premise of the Release appears to be that trading technology has advanced to the stage where it can replicate the operation of a central market or "board of trade" and that the presence of trading terminals in the United States might properly be viewed as the establishment of a domestic board of trade for which full "contract market" designation should be required.¹ We disagree with that premise. HKFE trading terminals are sophisticated *communication devices*, not trade execution facilities. While they represent a more efficient, more expeditious way to transmit orders to Hong Kong for execution and clearance there, the communications advancement represented by electronic terminals

¹ For the HKFE and, we believe, many other foreign boards of trade it would be commercially impossible to operate under "contract market" requirements because of the massive commitment of funds to U.S. facilities and personnel that would be entailed in addition to supporting the primary market abroad.

is probably no greater in magnitude than from the drum to the mail box, or from the semaphore to the telephone.

Moreover, attempting to adjust regulatory policies or standards in reaction to discrete technological developments would be futile. Seeking, for example, to define a point along the spectrum of technological refinement where a passive communications system becomes a market execution facility and therefore, potentially, a regulable "contract market" under current U.S. law² will not improve the quality of regulation and would be outdated very quickly. On the contrary, we believe that the Commission should seek to establish a set of regulatory standards and implementation procedures that are *indifferent* to technological change.

Significantly, the Release does not propose to adopt any new customer protections or to increase the level of existing standards that already apply to every form of trading platform. The prohibitions against fraud, misrepresentation, manipulation and other wrongdoing are intact and untouched. As the Release points out, the only effect of technology on the Commission's regulatory program is that it diminishes to some degree the active and visible participation of professional intermediaries (the "human element") in the various steps leading finally to trade execution. In many ways this is a *good* development because so many of the proscribed abuses occur during (and as a result of) the intermediation process. It is for this reason that the Commission's programs of licensing and auditing have always concentrated on those persons and entities that provide services to the ultimate buyers and sellers. In an electronic trading environment it is widely acknowledged that these problems would decline.

In the Release, we believe that the Commission has adequately addressed its concern that a reduced role for professional intermediaries in the trading process might weaken their *responsibility* and *accountability* for assuring that the customer protections and market integrity measures required by the Commission are fully and reliably delivered. By

² Whether an electronic trading system that is capable of connecting buyers and sellers without resort to intermediaries should even be characterized as a "board of trade" or "market" is open to debate.

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requiring that every person controlling a trading terminal for customer transactions must be a CFTC-registered futures commission merchant ("FCM") and that its terminal operators must be CFTC-registered associated persons ("APs"), the Commission has assured that no dilution of those obligations or of the Commission's ability to enforce them will occur.

Accordingly, we urge the Commission to uncouple its real regulatory concern - the continued viability of its regulatory program in an electronic environment where regulated intermediaries play a reduced transactional role - from fleeting technological states-of-the art. It is not productive or necessary to elevate the latest improvements in communications systems to the vaunted (and unworkable) status of "contract markets" so long as it remains clear not only what is required but *who* has the obligation to carry out those requirements.

B. Volume "Quotas" and Competition

While the HKFE agrees with the Release that care must be taken to discourage U.S. interests from creating *faux* "foreign" markets simply to avoid contract market designation, that risk is not materially different whether the "market" operates electronically or by more traditional means. Thus, the presence in the U.S. of trading terminals creates no presumption, either way, that the sponsoring board of trade is attempting to evade U.S. legal requirements. Evidence of that motive will be found, if at all, in other indicia such as control by U.S. interests, reliance of U.S. services for basic operating needs, minimal legal or practical contact with the alleged "home" jurisdiction, etc. Stated differently, a *legitimate* foreign board of trade like the HKFE is easy to recognize.

But the HKFE is especially concerned with the Release's suggestion that full Commission regulation might be appropriate if a foreign board of trade happens to derive a significant percentage of its trading volume from U.S. sources. Aside from the difficulties of administering such a standard (volumes change daily), we can envision few policies more likely to stifle international competition. If the consequence of brilliant product innovation, effective marketing, superior service and low cost result is garnering heavy U.S. patronage for a foreign market, it would be utterly inconsistent with American

antitrust laws including the Commission's commitment to promote competition³ for the Commission to respond by imposing the full burden of U.S. law and regulation on that exchange. Because a foreign board of trade is unlikely to be able to meet those demands on a commercially acceptable basis, a volume test would become a volume *quota* beyond which the foreign market faces major regulatory peril in the U.S. Moreover, if the "safe" volume is insufficient to support the product it may not emerge at all, or if that volume is adequate but less than the full business available, the U.S. contract markets could capture the overflow at no developmental or promotional cost. A volume-based test for whether a foreign board of trade must submit to the full regulatory rigors of a domestic contract market should be rejected.

C. Application of Part 30.10 Standards

The Release suggests that the Commission might include within its review process for U.S. terminal placement an analysis of the home jurisdiction's regulatory program to determine whether it is comparable to the Commission's own regulatory scheme. This process is analogized to the review conducted by the Commission when foreign boards of trade and their members petition under Regulation §30.10 for permission to deal directly with U.S. customers without registering as FCMs. The HKFE urges *against* adopting this step as inapposite, inordinately time-consuming and, for Part 30.10-approved persons, redundant.

The HKFE has not applied under Regulation §30.10 for this regulatory comparability relief but it understands that the review process can take many months (and substantial cost) to complete. Indeed, evidently for that reason, most foreign boards of trade have not undertaken that process. Here, the same burdens would be imposed but with two very compelling countervailing factors:

- (1) Unlike Part 30.10 relief, the review would *not* exempt member firms from FCM registration; on the contrary, FCM registration is proposed to apply under all circumstances; and

³ Commodity Exchange Act §15, 7 U.S.C. §19.

- (2) There is no evident justification for conducting such a review simply because communication would flow from an FCM via computers rather than from the FCM via telephone lines (as now occurs and would continue to be permissible *without* such vetting).

In HKFE's opinion, overlaying a Part 30.10-style analysis when U.S. customers continue to be serviced by fully-registered professionals is unnecessary and should not be adopted.

D. Placement of Terminals with Affiliated Entities

For many reasons that have nothing to do with the Commission or with its regulatory program, member firms of foreign boards of trade (like their American counterparts) frequently incorporate or organized separate entities to do business in different countries. Perhaps the most frequent consideration is managing the tax liabilities of multinational business enterprises. The HKFE *supports* the Release's suggestion that its member firms having *bona fide* U.S. affiliates should be able to place trading terminals in the offices (or floor booths) of those affiliates. This approach maximizes a firm's flexibility without any loss of regulatory control.

E. The Principle of Universal Reciprocity

The Release suggests that the Commission may include within its analysis of terminal placement requests a consideration whether American firms will enjoy comparable access if they seek it in the home jurisdiction of the foreign petitioner. We understand that certain U.S. contract markets have obtained and will continue to seek authorization to locate their trading terminals abroad. The HKFE *supports* this reciprocity standard, especially if it is applied uniformly among international regulators. Thus, for example, while the HKFE could not expect to enter the U.S. with its trading terminals if Hong Kong authorities were to wall out the American markets,⁴ foreign markets like the HKFE can take comfort that protectionist action within the U.S. would also be discouraged

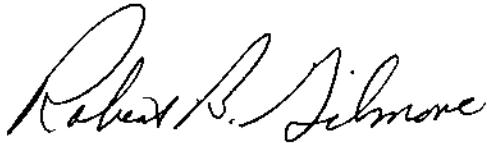
⁴ On the contrary, the Securities and Futures Commission has been very receptive to terminal placement requests from foreign markets.

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because it could provoke similar treatment of American markets seeking foreign expansion. Mutual reciprocity should stimulate reasonable accommodation of the interests of all markets worldwide.

We would be pleased to discuss the Release and any of the issues raised by it with the Members of the Commission and the relevant Commission staff officials.

Sincerely,

A handwritten signature in cursive script that reads "Robert B. Silmore". The signature is written in black ink and is positioned below the word "Sincerely,".

cc: The Honorable Brooksley Born
The Honorable Barbara Pedersen Holum
The Honorable John E. Tull, Jr.
The Honorable David D. Spears
I. Michael Greenberger, Esq.