Interactive Brokers' Steve Kelsey on Stock Index Futures:

As of January 8th, China's State Council approved short selling and margin trading in China. Essentially, this includes the launch of stock index futures, and gives the green light to pilot the margin trading business. As both of these investment vehicles are "shortable," this move will result in an end to the unilateral stock market in China, where trading "long" positions is currently the only way to make a profit. Insiders say that this is revolutionary in terms of institutional innovation, and that this is a far more significant move than those in the past, such as the reprehensible Growth Enterprise Board.

From the standpoint of a foreign securities company that is experienced with stock index futures, what is the current outlook on the Chinese market? While in the process of launching stock index futures, what possible risks should China be aware of and avoid?

Time Weekly arranged for an exclusive interview with Steve Kelsey, Managing Director of Asia-Pacific office of Interactive Brokers (hereinafter referred to as IB). As the largest independent broker-dealer in the U.S. for the last 32 years, Interactive Brokers provides electronic trading access to stocks, options, futures, forex, bonds and funds on over 80 market destinations in 18 countries. With consolidated equity capital of more than US $4.8 billion, IB and its affiliates exceed 1,000,000 trades per day.

Time Weekly: On January 8th, China Securities Regulatory Commission announced that the State Council approved short selling and a trial for margin trading, in addition to the launch of stock index futures in the A share market. Is this the right time for China to make these moves? What is your opinion on these developments?

Steve Kelsey: This is a great improvement in the development of China's capital market. Regardless of the timing, the absence of those tools was pitiful. Since the detailed regulation of stock index futures and margin trading is not yet available, I cannot give any specific comments on these subjects. However, I will say that the launch of these two investment vehicles will greatly improve price discovery and market-set prices.

The biggest advantage that China has now is the ability to learn from the mistakes that the U.S. has made in policymaking with regards to short selling. Related policies, such as the ban on short selling, which was implemented in the U.S. during the economic crisis, have been adjustments to policies that were made in time of trouble. This is a reactive system, but China has the opportunity to avoid similar mistakes and detours by being proactive in their policymaking.

With regards to the large contract size that has been announced, stock index futures were initially created for large financial institutions for hedging purposes. The initial contracts on S&P 500 Index Futures of the U.S., Nikkei 225 Index Futures of Japan, and Hang Seng Index Futures of Hong Kong, launched large size products first, and were followed by the E-mini size afterwards. To the overseas market, this is a smooth process. Eventually, trading volume of the E-mini S&P (which is five times smaller) has grown over ten times higher than that of S&P.

Time Weekly: What are the possible risks that China will face when launching such investment vehicles and how can they be avoided?

***Steve Kelsey**:* The key issue in the success of stock index futures is a powerful trading platform, because the system must be stable and reliable enough to handle massive information and data flow. In the past, there has been explosive growth in trading volume around the world after the launch of a new financial product; in this case, the trading platform will reach its technical limit in no time. Ten years ago, the trading platform of CME GLOBEX had these type of technical problems, but was later upgraded and is now a very stable and reliable platform. Another example is the Tokyo Stock Exchange in Japan, which has recently upgraded their trading system for derivatives. The system was upgraded to TDEX in the late half of 2009, and was just upgraded again to ARROWHEAD at the beginning of this year.

***Time Weekly**:* After launching stock index futures, China will be facing the issue of liquidity, which will have great impact on contracts. How do you think this problem can be solved?

***Steve Kelsey**:* Market makers are the best solution to this problem. In a financial market, the term "market maker" refers to independent securities dealers, who quote both buy and sell prices, and then undertake the act of selling and buying securities products on behalf of investors. With this model, traders do not have to wait for real trading counterparties, they can trade as long as there are market makers taking the opposite side of trades.

Market makers are referred to as 'dealers' in Hong Kong stock market, however, they differ greatly from domestic 'dealers' who actually are stock jobbers. Market makers keep quoting buy and sell prices that add to market depth and attract more traders to trade in the market, which in turn, helps the success of products. Major market participants like mutual funds will be more confident in entering the market only when they see quotes and market depth. In addition, it is very important to know how to exit the market.

Finally, before China launches stock index futures, it is necessary for broker-dealers, major private investors, broker agencies and their clients to become well-prepared to learn new lessons when entering the market.

***Time Weekly**:* Because the capital and financial account have not been opened up yet, Wall Street financial institutions are still not allowed to enter China's capital market. However, foreign financial institutions may get approved to trade stock index futures by using their quotas under the Qualified Foreign Institutional Investor (QFII) program. At present, what is IB capable of in China's market, compared to those of other Asia Pacific countries?

***Steve Kelsey**:* IB has clients in more than 140 countries, and we would love to assist China in globalizing its futures market. We are more than happy to share our experience in developing markets and market making to help market makers play a better part in the field of stock index futures. Given the opportunity, IB would also love to provide liquidity to China's market. IB has recently established a representative office in Shanghai, in order to strengthen research and prepare for connecting with China's market, as well as to more deeply enhance our cooperation with some institutions.

We have clients in more than 100 countries who are currently trading Hong Kong products. With IB, African and east European clients can trade in European markets. If their choice in brokers was limited to local companies, they would not be able to have access to these markets, but with IB, these clients are provided with the ability and opportunity to play globally and access the international markets.

In 1997, when the Hong Kong Stock Exchanged launched Hang Sent index Futures in electronic market, the IB office in Hong Kong was the only electronic market maker at that time. IB has gained experience with market making for the Hong Kong market, and become successful in advanced derivatives like options. Index options contracts include index options and index futures options. For the Hong Kong market, it is index options. Margin rules are the same as those for index futures.

***Time Weekly**:* Currently, many state-owned Chinese enterprises are incurring massive losses when trading derivatives with foreign investment banks. Do you have any suggestions for them?

***Steve Kelsey**:* Why not stop OTC trading and allow trading to happen in exchanges? International investment banks, using numerous mathematics tools, design highly complex derivatives with very limited transparency. In turn, traders have to take the risk of unsymmetrical information when buying these contracts. The more complicated or difficult the derivatives contracts are, the bigger the risks become. With these trades, the investment banks will bring in commissions or other income.

If supervision authorities wouold allow enterprises to enter into futures or other derivatives markets to trade, transactions will be more transparent. Instead of getting informed post trades, supervision authorities will be able to monitor trades at all times, as margins are monitored in real time in global futures markets. Daily transaction amount and margin changes of exchange trades are all available to be monitored. The settlement is done by central clearing houses, which protects traders from contract violations by their trading counterparties, therefore major risks or loss can be avoided as well.