



International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores

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Dr. Mario Draghi
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Financial Stability Board
Bank of International Settlements
Centralbahnplatz 2
CH-4002 Basel
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Subject: IOSCO's recommendations on market integrity and efficiency

Dear Mario,

In November 2010, the G-20 leaders, at their Seoul summit, requested that the International Organization of Securities Commissions (IOSCO) identify key challenges to and “develop by June 2011 and report to the Financial Stability Board (FSB) recommendations to promote markets’ integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments” such as high frequency trading.

I am now writing to you on behalf of the Technical Committee of IOSCO to outline the work, which is set out in detail in the attached Consultation Report on *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, undertaken in response to this mandate. I will also outline recent IOSCO work which includes recommendations that we believe are necessary to promoting and maintaining markets’ integrity and efficiency while mitigating the risks posed by technological and market changes, and our future work program in this regard.

Consultation Report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency

In this report IOSCO analyzes the most significant technological developments and related micro-structural issues that have arisen in financial markets in recent years, notably high frequency trading, and their impact on market structure, participants’ behaviour, price discovery and formation, and also on the availability and accessibility of liquidity. It also

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considers other micro-structural related topics such as co-location, tick sizes, fee structures, indications of interest etc., and presents an analysis on trading halts and circuit breakers.

The Report contains a number of questions to the financial services industry relating to, amongst others:

- the impact of technological developments;
- risk controls;
- trading controls;
- regulatory surveillance capabilities;
- conflicts of interest;
- fee structures; and
- co-location.

IOSCO has the aim of arriving at recommendations to address these issues and minimise the impact of these technological changes on market integrity and efficiency, and invites input from interested stakeholders in order to frame these recommendations. The consultation period will close on 12 August so that a further report can be prepared before the FSB and G20 Finance Ministers meet in October.

IOSCO considers that the broad issues of market structure and market surveillance capacity, including the costs of the additional surveillance capacity needed to adequately deal with these changes, require particular consideration. While we expect that the consultation will assist in clarifying the most pressing of these issues, we anticipate that further work will be needed in the medium term. Our future work plan in this regard is set out below.

IOSCO's work on market efficiency and integrity

IOSCO has also completed various pieces of work and made recommendations with the aim of improving market efficiency and integrity. In particular, it has produced policy recommendations in the following areas:

- **Principles for Dark Liquidity (May 2011)** - Principles have been designed to assist regulators in dealing with the issues posed to their oversight of markets by the expanded use of dark liquidity and the development of dark pools, particularly with respect to transparency.
- **Trading of OTC Derivatives (February 2011)** - IOSCO has concluded that it is appropriate to trade standardized derivatives products with a suitable level of liquidity

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on organized platforms, and that a flexible definition of what constitutes an organized platform would maximize the number of derivatives that can be appropriately traded on these venues. The report also has identified characteristics that organized platforms should exhibit in order to fulfil the G-20's objectives of improving transparency, mitigating systemic risk, and protecting against market abuse in the OTC derivatives markets.

- **Direct Electronic Access (August 2010)** - IOSCO has created a set of principles to guide intermediaries, markets and regulators to address the potential risks posed by direct electronic access to markets.
- **Transparency of Structured Finance Products (July 2010)** - IOSCO has set out recommendations for regulators seeking to enhance post-trade transparency in structured finance products.
- **Regulation of Short Selling (June 2009)** - IOSCO has developed principles for the effective regulation of short selling, the objective being to reduce the potential destabilizing effect that short selling, used in an abusive manner, can cause without exerting undue impact on market activities that are critical to capital formation and to reducing volatility such as hedging.

In addition, IOSCO has an ongoing work stream on Exchange-Traded Funds (ETFs). As ETFs are increasingly traded and have gained a prominent role in financial markets, IOSCO is undertaking work on these vehicles aimed at:

- i. examining the experience and key regulatory aspects regarding ETFs across IOSCO members;
- ii. identifying the common issues of concern; and
- iii. developing, if appropriate, a set of principles or best practices on ETF regulation to address the identified issues by early 2012.

IOSCO's further work plan

In the immediate post-crisis period, IOSCO first focused its work on stability issues in line with the G20 priorities as expressed in particular at the Pittsburgh Summit (Sept.2009) and the specific request from the G20 in Seoul (Nov.2010) related to technological developments impacting on market efficiency and integrity. Going forward, other potential areas may be identified for further IOSCO work in the medium term.

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In addition to the consultation on the impact of technological changes that will be undertaken with the publication of the attached report and the ongoing work on ETFs, IOSCO intends to undertake work designed to address fundamental questions linked to market surveillance and market structure as indicated in the following:

a) Work aiming for development of recommendations on market surveillance

- IOSCO will assess the new challenges that technological changes pose for regulators in their market surveillance which include: the fragmentation of markets; the dispersal of trading information; the increased speed of trading; and the ability to gather and process the increased volume of trading data.

It could consider the feasibility of regulators having additional tools to deal with the challenges arising from market surveillance, some of which may include:

- additional audit trail or surveillance data consisting of all orders and trades by market participants in a given instrument;
- a single reporting point for all orders and for all transactions, by jurisdiction or geographical zone and across asset classes; and
- unique entity identifiers.

These tools could improve the capacity of the regulators to cope with the increasing volume of data, from numerous sources of information, with increased speed that characterizes today's marketplace. Such tools could allow the proper treatment of data gathered from the market, giving regulators the opportunity to have access to orders and trades done, as well as to obtain market participants' information in a consistent manner.

- In addition, IOSCO will build on its work on supervisory cooperation to consider how best to enhance operational contacts and cooperation between regulators in order to more flexibly share information and views for day-to-day market supervision.

b) An analysis of the new market structure and its impact on market efficiency/integrity

- IOSCO will analyze the evolving markets' macro-structure, in order to assess what specific issues such structural developments raise with regard to market efficiency and integrity; and consider whether and what recommendations may be needed to address any risks.



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Conclusion

I recommend that the FSB:

- Note the publication of the Consultation Report on *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, focussed on high frequency trading and its impact on market structure, participants' behaviour, price discovery and formation, and on the availability and accessibility of liquidity;
- Endorse the standards and recommendations already developed by IOSCO outlined above, as being the base international standards that should be adhered to by securities regulators in order to address risks posed by other market developments including dark pools of liquidity; and
- Note the further work program outlined above to address issues related to market surveillance and market structure.

We will contact the FSB Secretariat shortly to arrange a convenient time for a direct discussion regarding the contents of this report and the recommendations IOSCO sees as being essential in meeting the G20's aims and objectives.

It is IOSCO's intention to publish this report during this week.

If you need any additional information or would like to discuss this further, please do not hesitate to contact me or Mr. Greg Tanzer, Secretary General of IOSCO.

Yours sincerely,

Masamichi Kono
Chairman
Technical Committee
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