Response from Securities & Exchange Commission Pakistan

I am writing from the Securities & Exchange Commission Pakistan (SECP) in relation to the Public Comment on the Consultation Report titled ***"Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency".***

I would like to inform you that a number of concerns covered in the report are not directly relevant to our markets in Pakistan as they involve complex models and strategies, which are currently not practiced in Pakistan. Nonetheless, we have tried to respond to the questions posed to member jurisdictions in Chapter 5 of the report to the best of our knowledge and understanding.

Q1 – The technological developments mentioned in the report are not presently practiced in Pakistan, however various other technological advancements such as automation of securities transfers at the Central Securities Depository and direct electronic access to trading avenues have created efficiency in trading and related activities and have helped in increasing market activity.

Q2 – Normally proprietary trading firms are members of stock exchanges themselves in Pakistan and are required by regulators to register with them. Such firms should be required to adhere to regulatory requirements for market participants particularly relating to conflict of interest and prohibition of market abuse, as such firms also trade on behalf of clients. In general, all brokers are allowed to trade in proprietary accounts in Pakistan.

If such firms are not members of stock exchanges and are clients of an intermediary, they don't need to register separately with the regulator, as they are not required to adhere to regulatory requirements pertaining directly to an intermediary.

Q3 – With reference to HFT and algorithmic trading, the regulators should have proper audit trail to trace back the origination of transactions and to identify the cause of market disruptions should they occur. In relation to pre-trade risk controls, regulators need to put in place requirements which ensure transparency of trading strategies. Such requirements and restrictions may be system based to limit the undue exposure of such trading strategies. Further, one of the main risks that regulators would need to focus on and monitor is that HFT should not lead to situations which can cause systemic risk through reducing competition amongst market participants due to trading in a low number of securities, thus eliminating competition and concentrating in a few well capitalized companies.

Q4 – Circuit breakers should be mandated by regulators, in a way that balances the aspects that the securities prices are not swayed unusually nor such arrangements hamper the price discovery process of the market. Normally, circuit breakers are in place to limit the risk of excess volatility faced by market participants, but they should rather be more encompassing the overall market to regularize the market movement trend, rather than be based on individual securities. Further circuit breakers need to be well thought of so that the benefits associated with circuit breakers should outweigh the costs. Such controls should not be set specifically by the venue operators separately and should be part of an overall market risk management plan. In Pakistan downward circuit breakers of 5% are in place while upward circuit breakers of 7.5% are in place.

Q5 – The rationale for having a market maker is to provide liquidity by reducing the bid/ offer spread and through consistent quotation of bids and offers. Unless there is a

minimum criteria for such quotation of bids/ offers, the purpose for introducing market makers is defeated. Further, since the process involves excessive trading by a market maker, minimum financial conditions for the entity performing market making are also required to ensure it has the capacity to provide such services thereby reducing any occurrences of default. Considering that trading venues, i.e. exchanges, regulate the markets and oversee their risk management, they should determine the criteria, however through consultation with the market participants considering their stake in the process.

The use of stub quotes should be prohibited or at least restricted to a certain extent to ensure that the market maker is required to perform its primary obligation of creating liquidity in the market. Otherwise, the use of stub quotes, if allowed may lead to decreased or no liquidity and in some cases even malpractices in the market.

Q6 – Technological innovations have presented regulators with the task of analyzing new and complex trading patterns therefore regulators must be in a position to analyze trading patterns and classify their characteristics whcich could be done through the use of specialized staff that has knowledge of these techniques and who are able to develop the necessary regulatory tools themselves. The Regulators should have surveillance capabilities particularly in reference to pattern detection and to oversee and detect activities such as front-running and other manipulative practices. Such capabilities should include systems and techniques aimed at identifying and possibly re-playing the market activity to assess the suspected manipulative scheme and its likely implication. Regulators should also have in place systems. In addition to this, the surveillance capabilities for inter-market trading strategies should be implemented to oversee the complex trading strategies involving multiple markets and assets/products. Such investment costs should be borne by the regulators implementing such capabilities.

Q7 – Settlement failures and irregularities may be attributed to a number of factors and causes. Firstly, a settlement failure can be caused by a computer failure or disruption, whereby automated systems may reject the instructions and impede the settlement completion by settlement date. Another cause of settlement failure is liquidity shortfall, such as in derivative markets where physical delivery is accorded. At times, the underlying asset may be short in liquidity to complete settlement. Similarly, in short-selling arrangements, if the short-seller has not managed to borrow the securities for delivery, it will cause a settlement failure.

Other more specific reasons for settlement failure that vary across jurisdictions include the cost and penalties in case of settlement failure. It may be noted that if the cost of settlement failure is low compared to borrowing the assets/funds to accomplish the settlement, the defaulting party will have less incentive to take corrective measure to avoid such failure. Another settlement failure may arise due to trading strategies involving different assets and products, where the settlement cycle of those assets and products may differ.

The regulators should make requirements and policies which bind the traders and market participants to manage their operational and liquidity risks effectively, for instance like banks. Moreover, the regulators should make the penalties stringent in case of securities settlement failure to prohibit traders who avoid the failure deliberately or otherwise.

Q8 – Conflict of interest can be catered by elimination of such conflict or management of the same with the priority being given to customers. This should be in addition to proper

and appropriate disclosure. Currently, the conflict management is limited to less preemptive measures like prohibition on firms from trading in proprietary accounts while trading for clients. However, a more effective control environment is inevitable in proper reduction and management of conflicts. Measures which can be adopted by regulators include clear and concise policies, adequate disclosure requirements and specific prohibitions and stringent penalties to counter the problems associated with conflict of interest.

Q9 – Normally in our jurisdiction, computer generated orders are not common due to lack of complex trading strategies, however, the stock exchange trading systems allow for various types of orders with different characteristics.

Q10 – Complex trading strategies are not commonly used in Pakistan, however we feel that market making strategies employed by HFT firms are a particular concern as it could lead to liquidity being provided to only a few stocks and in the process eliminating competition thus posing a problem to the integrity of the market.

Q11 – The Regulators should monitor closely the traders who have high order-to-trade frequency and may impose charges if frequency is high of such trades.

Q12 – Co-location services are provided by market participants in Pakistan, but due to lack of use of complex trading strategies don't make any particular difference in information requirement by various trading system operators. However market operators should be required to make their co-location services fair and non-discriminatory and regulators must be able to take effective action against market participants who abuse the low latency they obtain for manipulative purposes.

Q13 – It seems plausible that market operators should provide testing environments to participants, and it would enhance their capability of assessing their overall risk under extreme market circumstances. Market participants must sufficiently test the algorithms and the trading strategies which they plan to implement, so that the functioning of an algorithm can be evaluated in a wide variety of situations. The minimum requirements should include a variety of scenarios ranging from worst variable movements to testing for black swan events which would lower the probability of systemic risk. Moreover, participants should be required to stress test their algorithms at least annually to assess their risk in changing circumstances.

Q14 – As conceived from the definitions of market integrity and market efficiency definitions given by IOSCO on page 8 of the report, it should be noted that short-term investors or high frequency traders may help in enhancing liquidity and price discovery process and in turn help to foster market efficiency, but there should be stronger policies and rules in place by regulators to prohibit such traders from negatively affecting market integrity, which normally is tied to long term investment and capital formation. These innovative trading strategies as described in the report have further increased the dependence of financial markets on technology. Trading strategies concern the actual behaviour of the market participants using these strategies. In so far as participants are using legitimate strategies, they should be treated exactly like other market participants. If the strategies are not legitimate and involve market abuse, action needs to be taken. In itself, such strategies cannot be considered to lead to market abuse. The regulators role should not be to prescribe the speed or time horizon with which trades can be executed, or

to prevent market participants from realising the legitimate profits that result from their investment in technology.

I hope our comments prove beneficial to you. In case of any queries on the above kindly let me know.

Best regards,

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