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

A Response by the Futures and Options Association

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1. Introduction

1.1 The Futures and Options Association ("the FOA") is the principal European industry association for over 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA welcomes this opportunity of being able to comment on IOSCO's consultation report on "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency". We support the objective of this work, to "assess the impact of technological developments on market integrity and efficiency … to seek to ensure that financial markets continue to fulfil their role of financing the real economy."

1.3 We believe it is clear that further research is needed to properly assess the impact of technological changes on markets. We urge IOSCO to seek out reliable and independent evidence when developing principles for regulation in this area.

2. Responses to Questions

Q1:

What impact have the technological developments in the markets in recent years had on your own trading? Has it encouraged, discouraged or had no impact on your willingness to participate on the lit markets, and how does this differ between asset classes and/or instruments?

2.1 Not applicable to the FOA.

Q2:

What are your views on the suggestion that proprietary trading firms (including HFT firms) that are not currently subject to registration/authorisation by a regulator should be required to obtain such a registration/authorisation? Are there specific regulatory requirements you believe such firms should face?

To what extent do your answers differ if the proprietary trading firm accesses the market as the customer of an intermediary firm through DEA (i.e. under that intermediary's trading rules/codes) rather than as a direct member of the market itself?

2.2 The underlying test of whether or not a firm should be subject to registration/authorisation requirements by a regulator is based largely on the business being undertaken by the firm and with whom, and not on how it is undertaking that business (which is a matter for on-going regulation and supervision).

We believe, therefore, that a proprietary trading firm (a firm dealing a principal and not as agent) which is a direct member of a trading venue should be subject to the registration or authorisation requirements of the relevant regulator. This is to ensure that these firms are subject to appropriate, independent regulatory oversight, including transaction reporting requirements. A reduced set of requirements should apply to firms that do not have clients.

If, however, the proprietary trading firm accesses the market as the customer of an intermediary firm through direct electronic access (i.e. under that intermediary's trading rules/codes) then it should not be subject to registration or authorisation requirements.

Q3:

What recommendations, if any, would you propose to strengthen the regulatory requirements around pre- and post-trade risk controls? In particular, what measures, if any, do you think regulators should introduce that relate specifically to the use of and risks posed by algorithmic trading and/or HFT?

2.3 We believe it should be mandated that trading venues provide pre- and post- trade risk management functionality. We believe there is a need for rules similar to those of the SEC which prohibit broker-dealers from providing customers with "unfiltered" or "naked" access to an exchange or ATS. SEC's rules also require brokers with market access — including those who sponsor customers' access to an exchange or ATS — to put in place risk management controls and supervisory procedures to help prevent erroneous orders, breaches in trading limits and ensure compliance with regulatory requirements, including pre-set credit or capital thresholds. Where such controls must be applied pre-trade, we believe that this should happen at the exchange level to ensure that all orders are subject to the same latency impact.

The FIA's Market Access Risk Management Recommendations (April 2010)[1] set out the controls we believe trading venues should put in place in this regard. These include, inter alia, 'fat finger' or order size limits, cancel-on-disconnect functionality, kill or stop buttons, price limits/controls and error trade policies.

In response to whether regulators should introduce measures that relate specifically to algorithmic trading and/or HFT, it is difficult (and we believe unnecessary) to carve out measures that should apply specifically to this type of trading.

Q4:

To what extent do you believe the use of trading control mechanisms such as circuit breakers and limit-up/limit-down systems by trading venues should be mandated? If you believe they should be mandated, should venue operators be permitted to design their own controls or should they be harmonised/coordinated across venues (including between interrelated instruments such as a derivative and its underlying)?

2.4 Many derivative markets already employ trading control mechanisms such as circuit breakers and limit-up/limit-down systems. However, these are not used in a harmonised way across trading venues. We believe there is value in mandating the harmonisation/coordination of these controls for like markets and on a global basis, since this would avoid any arbitrage

[1] http://www.futuresindustry.org/downloads/Market_Access-6.pdf

between like venues, and may also help to reduce volatility between such markets. Harmonised rules would need to be carefully calibrated in cooperation with market participants. We would also like to recommend that trading venues adopt the use of volatility mitigation mechanisms which involve the introduction of a brief pause to the market following the triggering of a circuit breaker, as opposed to an actual trading halt which can severely limits market participants' ability to manage their risk. Both the CME and Eurex employ such mechanisms.

We also believe that transparency and clarity in criteria is needed with respect to the erroneous trade policy of each trading venue. Participants need to have certainty on whether trades executed in a volatile market will stand or will be broken and in what circumstances. We believe this certainty would encourage market makers to continue to provide liquidity during volatile and high volume market conditions.

Q5:

To what extent do you believe market maker schemes offered by trading venues should be subject to mandatory minimum criteria? Should the criteria be determined by the trading venue alone? To what extent do you agree with the suggestion that the use of stub quotes should be prohibited?

2.5 No, we do not believe that market maker schemes offered by trading venues should be subject to mandatory minimum criteria. In our view, these are commercial decisions that are best left to the trading venues and then to the trading members in deciding whether to participate in these schemes.

We are not clear on what problem would be solved by applying mandatory minimum criteria to market maker schemes. We are aware of the current debate on whether there is an issue with "bad" or "good" liquidity in markets. As no doubt IOSCO appreciates, compelling market participants to provide liquidity in extreme market conditions would likely discourage participation in the market altogether, thereby removing the benefits of the liquidity they currently provide on a voluntary basis. Mandating liquidity provision could also create prudential risks for these firms by exposing them to market movements when other participants are free to withdraw.

The FOA agrees with the suggestion that the use of stub quotes should be prohibited.

Q6:

Do you have suggestions for improvements to regulators' surveillance capabilities with respect to the markets and modern trading techniques? Please elaborate.

Who should bear the cost of investing in such capabilities and the cost of operating and supervising the markets in order to ensure fairness among market participants? Please elaborate.

2.6 A significant amount of transaction and position data is already collected by regulators for the markets they monitor. It is also anticipated that additional data will be collected with respect to OTC derivatives transactions under the European Markets Infrastructure Regulation (EMIR),

with such data being recorded and warehoused in trade repositories. Regulators' surveillance abilities will likely be significantly enhanced by having access to this broader data set.

That being said, we appreciate that regulators are reviewing their surveillance capabilities in light of the significant changes in market practice and technology over the last few years. A thorough cost/benefit analysis should be central to decisions for significant spending in this area. Regulators providing a clear description of what they regard as the main risks involved with modern trading techniques (and how these should be monitored) will also help firms and trading venues address these risks in their trading systems.

Additional cooperation and harmonisation of approach between regulators would foster an efficient use of resources and surveillance capabilities. Firms would likely benefit from a higher degree of consistency from regulators and exchanges through adopting more consistent controls and techniques and thereby optimizing their own surveillances capabilities.

One suggestion for enabling firms to perform more effective surveillance would be for trading venues to provide member firms with pre- (order drop-copies) and post-trade (real-time execution confirmations) data for that firm's order data in an electronic format and on a cost-only basis.

Q7:

What do you perceive as the major causes of settlement indiscipline and settlement failures? What steps, if any, do you believe regulators should take to address these causes?

2.7 We are not aware of a problem in this area, so do not see the need for regulatory action.

Q8:

Have the appropriate steps been taken to limit or manage conflicts of interest that arise where an investment firm simultaneously conducts client-serving activities and proprietary trading or a trading participant is also a shareholder in a venue on which it trades? If you believe conflicts management is inadequate, please explain how this manifests itself and any recommendation you have for how conflicts management could be improved.

2.8 The FOA believes that the existing rules governing customer priority, conflicts of interest management and the prevention of market abusive behaviours are sufficient.

Q9.

Do you think existing laws and rules on market abuse and disorderly trading cover computer generated orders and are relevant in today's market environment?

2.9 The FOA believes that the existing laws, rules and systems and controls for identifying, monitoring and preventing market abuse and disorderly trading are appropriate to cover computer generated orders. The FOA is of the view that the principles of the rules to prevent market abuse and disorderly trading are neutral to the method of execution of the transaction

i.e. it is the actual trading strategy that is abusive – not the fact that technology is used to generate the actual orders associated with that strategy.

Q10.

Are there any strategies employed by HFT firms that raise particular concerns? If so, how would you recommend that regulators address them?

2.10 We are not aware of any trading strategies employed by HFT firms in the listed futures and options markets that raise particular concerns.

Q11.

Should charges or fees be imposed on messages, cancellations or high order-to-trade ratios? If so, how should the fees or charges be determined and on what basis?

2.11 Whether such charges are appropriate should be a decision for the trading venue itself. In making such a decision, the venue will take a range of factors into account such as the type of products it trades, how best to facilitate the trading strategies employed by its users and its own IT infrastructure capabilities, but maintaining market integrity and orderliness will always remain paramount.

It should not be the responsibility of the regulator to intervene in such commercial pricing policies – provided the pricing model is transparent, non-discriminatory and does not constitute an abuse of market power, this should be left to the trading venues themselves.

Q12.

Should market operators be required to make their co-location services available on a fair and non-discriminatory basis?

2.12 Yes, the FOA believes that market operators should be required to offer co-location services on a fair and non-discriminatory basis. If there is a methodology or rationale used by the market operator to ration access to co-location services, this methodology and the reasons for any restrictions should be made known to all members and/or prospective purchasers of co-location services.

Where proximity hosting services are similarly provided, market operators should also be required to permit, on a fair and non-discriminatory basis, the provision of equivalent services to market members by third party providers.

Q13.

Should market operators be required to provide testing environments to enable participants in stress test their algorithms? If so, what kind of minimum requirements are reasonable?

2.13 Yes, market operators should provide testing environments to permit the testing of automated trading systems prior to them being 'released' into the live markets. However, the value of such testing will be dependent upon test criteria being set at an appropriate level.

The exact requirements should be agreed between the market operator and its users, however it is important that these test environments are made available at reasonable cost and for sufficient time to permit comprehensive testing.

Q14.

To what extent do you have other comments related to the risks to market integrity and efficiency raised by the issues in this report?

2.14 In this section we have addressed some of the ideas put forward in the "Possible Future Actions" part of IOSCO's paper which begin on page 38.

2.15 On page 38, it is suggested that "market authorities should consider whether tailored regulatory requirements should be introduced, especially in those markets where algorithmic trading or HFT is a dominant component of the market structure. Some presenters suggested that this might include anything from specific stress testing and sign-off processes for new algorithms, to specific charges or a tax on high order entry or cancellation rates". We see no evidence as to why HFT should be treated any differently from the rest of electronic trading. Existing rules & regulations (including existing futures exchange message ratio policies) are sufficient.

2.16 We agree with the suggestion on page 38 that there could be a 'review' of existing regulatory requirements regarding pre-trade risk controls applicable to intermediaries in order to evaluate whether they are suitable for today's high-speed markets. Part of this review should consider banning the provision of Direct Electronic Access (DEA) to customers if the customer's trading is not subject to appropriate pre-trade controls (i.e. so-called *naked access*), where it is not already banned in accordance with IOSCO's Principles 6 and 7 for DEA. In response, we strongly agree that naked access should be banned. There is currently a lack of clarity in terms of this rule for derivatives markets.

2.17 Ideas put forward on page 38 also include the suggestion of assessing whether or not HFT or algorithm traders should provide for specific forms of stress testing and internal sign-off processes for new algorithms, similar to IOSCO's Principle 8 for DEA. We do not feel that it would be practical or valuable to define specific stress tests or sign-off processes as every strategy as well as its testing requirements is different. However, we believe that the market in general would benefit from higher quality exchange testing environments.

2.18 On page 39, IOSCO suggests that 'common trade cancellation arrangements be put in place across markets to ensure consistent treatment in the event of a sudden extreme price movement. These arrangements should be coherent in their operation with any order entry controls and volatility controls'. We agree with this suggestion, providing it is proportionate, transparent and exercised in accordance with clearly articulated criteria. This is important because of the potential high commercial consequences for firms and, as and where appropriate, any customers in terms of trade cancellations.

2.19 The Report also suggests the introduction of minimum tick sizes, and minimum order bookresting time. We are not aware of specific problems with how the market currently functions in these areas and therefore see no need for regulatory intervention.

2.20 IOSCO also suggests requiring that market infrastructure operators undertake appropriate stress testing to ensure that their systems are robust in the face of unusual spikes in trading activity, as per IOSCO's Principle 8 for Direct Electronic Access. We agree with this suggestion and that it should include front-to-back testing.

2.21 IOSCO also suggests evaluating what could be done 'to improve market surveillance, taking into account the needs of different market structures'.

Key steps should include:

(a) A high-level of surveillance of potential unfair activity by market participants;

(b) The implementation of up-to-date order screening/monitoring tools (either by the trading venue operators or by the competent authorities) to help identify trading patterns and prevent inappropriate trading behaviour;

(c) The introduction of consolidated *audit trails* capable of tracking orders, quotes and trades in the market;

(d) The introduction of large trader reporting requirements (where these do not already exist); and

(e) The introduction of the use of entity identifiers to identify trading on a participant-by-participant basis or to flag algorithmic/HFT orders.

In our view, more transparency from trading venues with respect to their surveillance activities would strengthen the perceived integrity of the markets. In terms of any additional regulatory requirements, a thorough cost/benefit analysis should be performed after specific risks and objectives are identified.

APPENDIX 1

List of FOA Members

FINANCIAL INSTITUTIONS
ABN AMRO Clearing Bank N.V.
ADM Investor Services International Ltd
AMT Futures Limited
Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd

BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
ETX Capital
Fortis Bank Global Clearing NV - London
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JB Drax Honoré
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
RBS Greenwich Futures
Royal Bank of Canada
Saxo Bank A/S
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
State Street GMBH London Branch
The Bank of Nova Scotia
The Kyte Group Limited
Tullett Prebon (Securities) Ltd
UBS Limited
Vantage Capital Markets LLP
Wells Fargo Securities International Limited
WorldSpreads Limited

EXCHANGE/CLEARING HOUSES
APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
EDX London
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading Ltd
Cargill Plc
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
RBS Sempra Metals
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Triland Metals Ltd
Vitol SA

ENERGY COMPANIES
ALPIQ Holding AG
BP Oil International Limited
Centrica Energy Limited
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Trading Ltd
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Actimize UK Ltd
Ashurst LLP
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Complinet
Deloitte
Dewey & LeBoeuf LLP
Exchange Consulting Group Ltd
FfastFill
Fidessa Plc
Financial Technologies India
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman Cornish LLP
KPMG
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
PA Consulting Group
R3D Systems Ltd
Reed Smith LLP
Rostron Parry Ltd
RTS Realtime Systems Ltd
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SNR Denton UK LLP
Speechly Bircham LLP
SunGard Futures Systems
Swiss Futures and Options Association
Total Global Steel Ltd
Traiana Inc
Travers Smith LLP
Trayport Limited