Investment Management Association

11 August 2011

Mr Werner Bijkerk
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Dear Mr Bijkerk

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

The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £4trn of assets as at the end of 2010, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pension and life funds), private client accounts and a wide range of pooled investment vehicles.

The IMA is pleased to respond to the above consultation. As a trade association rather than a market participant the IMA's response to your consultation reflects the consensus views of our members and refers to secondary equity market trading.

The key points we would make are:

- Technological advances cannot be rolled back.
- Intra-day trading is not new.
- Traditional institutional investors have benefitted from algorithmic trading in reducing transaction costs, specifically in securities which trade large volumes.
- Exchanges and market operators, while encouraging high volume trading, should assess and monitor the activity of its members to ensure that it does not impair their own systems and cause a market breakdown.
- Consideration should be given by regulators and/or market operators to charging a fee on excessive volumes of cancellations.
- Ensuring regulation covers all proprietary trading firms is a start; additionally, regulators should more closely monitor their activity and understand which firms are systemically or locally important. This may involve (where the two responsibilities are split) market regulators and firm supervisors co-ordinating additional requirements upon some firms.

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- Proprietary trading is concentrated predominantly upon the larger capitalised issuers with highly liquid stocks and does not have as significant impact on the trading of small to medium capitalisation shares.

Should you have further queries regarding this response then please do not hesitate to contact me.

Yours sincerely

Liz Rae
Senior Adviser Investment and Markets

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?

Technological developments have resulted in increased usage of smart order routing, algorithmic trading and direct market access by IMA members. This has also been accompanied by the buy side taking more control of its trading and execution than it had previously.

Since the implementation of MiFID in the EU in 2007, market fragmentation has been the main driver behind our members' increased usage of dark liquidity. This fragmentation has resulted in more but smaller pools of liquidity as new trading venues have been established. Our members are investing on behalf of institutions and are typically executing large order sizes which are not now available on lit markets where order sizes have declined significantly. This is partly due to the emergence of high frequency trading (HFT) which is facilitated by the highly sophisticated application of technology and where trading is characterised by high volumes of very small orders. There is a perception amongst IMA members that HFT is 'getting in the way' of traditional execution strategies and are more wary of displaying orders on lit markets; some members however have stronger opinions and characterise HFT activity as predatory, in both lit and unlit markets.

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?

IMA members believe that the same standards of risk management and of capital requirements should be applied to all market participants including proprietary trading firms. As a start, in principle all proprietary trading firms should be registered/authorised. We do not however believe that there are specific regulatory requirements that firms such as HFTs should face, but we do believe that regulators should know who the systemically important firms are, should have sight of what they are doing and should require all trading firms to transaction report. We recognise there will be a need to distinguish between firms whose sole undertaking is proprietary trading and those individuals who may carry out trading for their own account or mere members of the public (the latter groups being the type of firm and person which most regulatory exemptions from registration have in mind). If a firm has direct access then it should be registered, but we also consider that the dedicated proprietary traders should be registered whether or not using sponsored access; such firms should also transaction report.

It will be important to consider how firms will seek to avoid any regulation. Measures must ensure that investment banks are not able to provide an equivalent high-frequency exposure to clients by the use of a master swap arrangement that legally does not involve the high-frequency trader buying any shares but will cause the bank to hedge in similar fashion.

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?
IMA members do not believe that it would be practicable for firms to register their algorithms with regulators. Firms who use algorithmic trading are sufficiently motivated by the possibility of making a significant loss to ensure rigorous back testing and monitoring of their own algorithms. Registration would be cumbersome and inefficient and we query what regulators would do with such information. General obligations on risk management undoubtedly cover such activities but tailored and more specified obligations could be introduced to provide guidance.

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)?
IMA members believe that circuit breakers are an essential tool when there is a market breakdown and a pause is needed to restore equilibrium. We are not convinced any single model should be mandated nor that the optimal solutions have yet been found but we do accept that in order to restore equilibrium in as short a time as possible any circuit breaker regime should be standardised across all trading venues. Different regimes could give unfair advantage to some participants.

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?
IMA members agree that market maker schemes could be subject to mandatory minimum criteria which should be determined by the trading venue. At this stage we would support measures (if needed) which made it clear that trading venues may impose such criteria. Market experience of different criteria in future disruptions will assist in improving their calibration; we do not consider the evidence is available to suggest a single approach would help. We agree that stub quotes of the sort described in the consultation should be banned as they serve no useful purpose. The issue however is determining what indeed constitutes an acceptable quote.

Q6. Do you have suggestions for improvements to regulators' surveillance capabilities with respect to the markets and modern trading techniques? Please elaborate.
See answer to Q2. Regulators need to be aware of which firms are systemically or locally important particularly with reference to maintaining orderly markets and perhaps supervision needs to be strengthened by better analysis of transaction reports. In addition market abuse regimes can be enforced if regulators suspect that participants are misleading or manipulating the market by the placing and near immediate cancellation or orders.

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?
We currently have no data to assist.

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.

IMA members believe that in the EU the MiFID regime could sufficiently address the management of conflicts of interest of investment firms who are required to establish, implement and maintain an effective conflicts of interest policy. The key is that there is then sufficient supervision and enforcement to ensure that firms do adhere to their conflicts policies.

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?

While a person who places an order by telephone may have inside information or be committing market manipulation, a computer generated order, which is pre-programmed, is automated and cannot be expected to be acting unlawfully. If a market participant using an algorithm however has inside information about a specific security in that algorithm, then that security should be immediately removed. Existing laws and rules frequently presume some mental content to the cause or effecting of a trade; that is hard to apply to algorithms. It is important that such rules do not presume the existence of an actor with mental capacity but look rather at the impact. This is not to say that all forms of abuse are as egregious, just that in markets a event may cause disorderliness or damage market integrity without a person intending such an effect. It is necessary to provide a disincentive to such behaviour.

Q10. Are there any strategies employed by HFT firms that raise particular concerns? If so, how would you recommend that regulators address them?

The main concern of IMA members is the high order cancellation rate which characterises HFT firms. Concern centres on whether HFT firms are misleading the market by placing orders and then immediately cancelling them. We recommend that regulators and/or market operators consider whether a small charge be made when cancellation rates are excessively high.

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?

See Q10.

Q12. Should market operators be required to make their co-location services available on a fair and non-discriminatory basis?

Yes.

Q13. Should market operators be required to provide testing environments to enable participants to stress test their algorithms? If so, what kind of minimum requirements are reasonable?

We are not clear that market operators should be required to provide testing environments as we believe that participants do their own extensive algorithm stress testing. We do however believe that market operators should be clear and obtain reassurance that any activity by their members who are co-located does not impair their own systems causing market disruption. Operators should monitor their members' activity and address any problems e.g. excessive levels of volume causing system strains.

Q14. To what extent do you have other comments related to the risk to market integrity and efficiency raised by the issues in this report?

IMA members would not support minimum order resting times which would disrupt their own trading and execution. It would be possible for a market to operate on an auction basis which might avoid some of the HFT impacts – though it may introduce other problems if operated alongside a continuous trading venue.