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IOSCO consultation on the Impact of Technological Changes on Market Integrity and Efficiency

BTPS Management strongly welcomes this paper from IOSCO and the issues which it raises. We welcome the opportunity to comment. By way of background, the BT Pension Scheme is the UK's largest corporate pension scheme, managing assets worth around £35 billion and responsible for some 340,000 beneficiaries under a defined benefit (DB) structure.

As ultimate asset owners, pension schemes have a strong interest in transparent and efficient markets. These will most efficiently deliver the capital allocation and capital growth benefits which financial markets offer. We note that most participants in the financial markets are not ultimate asset owners, or principals; rather they are agents. Many agents will benefit either directly or indirectly from market inefficiencies and a lack of transparency, using this to gain trading advantages which they try to hold exclusively for themselves. Our firm view is that market regulation needs to favour transparency and efficiency and work to ensure that market structures and practices are not skewed to the benefit of a limited group of market participants.

We believe that the intention to reassess whether the right balance has been struck in regulation is highly appropriate. We believe in particular that this reassessment is important and necessary both in terms of competition between trading markets as compared with transparent on-market trading, and in relation to whether certain specific activities associated with high-frequency trading are abusive of the markets.

We would note one key element which should underpin IOSCO's and national regulators' consideration of these issues: what characteristics of liquidity are of most value economically and so which forms of liquidity should be most fully facilitated by regulation. In particular, we would ask whether the paper's chosen definition of liquidity as "the ability to trade large size quickly, at a low cost, when you want" fully captures the nature of liquidity which provides economic value. Rather, we believe a better and more valuable definition of liquidity includes the consideration that it should be possible to trade at scale <u>without having a significant impact on pricing</u>. We note that the nature and intent of many high-frequency trading algorithms is expressly contrary to this ability. We would welcome IOSCO and national regulators considering what form of liquidity they are most seeking to encourage and facilitate.

We would also note that beyond a certain level, we do not believe that additional liquidity adds anything to the process of price discovery. Rather, we believe that additional liquidity after a point simply favours additional trading activity, which may in fact drive trend-following behaviours in investment markets, leading to a greater propensity to bubbles and busts.

We respond to IOSCO's specific questions below.

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?

As with most investors, we have found ourselves obliged to shift trading into less visible venues or routes to the markets. In essence, this has meant a shift from trading directly in the markets to handing responsibility for trading to those more able to use dark liquidity and to split larger trades into smaller packets, or to a greater use of derivatives. As the paper suggests, this movement to conceal activities has always been a feature of the market; it is just that the more sophisticated ways of detecting trading mean that investors which do not use increasingly sophisticated (and increasingly costly) methods to conceal their activities are more likely to be identified and so suffer the burdens of being traded ahead. The concern is that failing to use these sophisticated routes to the markets exposes us to additional frictional costs as algorithms and other high frequency trading identifies our activity and shaves basis points from the value we might otherwise obtain. However, instead of these frictional costs, we face other costs in terms of the charges from those we hire to trade on our behalf. The broader impact is that there is less activity on lit markets (or indeed in the underlying assets at all), reducing the ability of markets to generate transparent pricing signals.

We thus welcome the proposal to consider whether the appropriate balance has been struck between encouraging competition between trading spaces and promoting the use of transparent, on-venue trading.

The paper quotes one definition of liquidity as "the ability to trade large size quickly, at a low cost, when you want". We would note that most definitions of liquidity consider that it is the ability to trade at scale <u>without having a significant impact on pricing</u>; the nature and intent of many high frequency trading algorithms is expressly contrary to this ability. We would suggest therefore that a clear view needs to be taken as to what characteristics of liquidity provide most economic value as a foundation for any policy-making in this area.

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?

We believe that participants in the market should face a level playing field of regulation and oversight. We do not believe that in practice there is a difference between accessing the market through DEA or otherwise.

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?

We have no specific recommendations on this point, though we would welcome active consideration being given to the proposal regarding banning the provision of DEA to customers whose trading is not subject to appropriate pre-trade controls.

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)?

We believe that the events of the flash crash suggest that there is a clear need for circuit breakers to be put in place. While circuit breakers do by their nature have a negative impact on liquidity and activity we believe that the pause in trading which they apply can be highly valuable in extreme circumstances. However, we would suggest that given the crash appears to have arisen at least in part through the interaction of modern technological trading with specific US market rules, those circuit breakers will need to be different in different markets to respond to their specific circumstances. So we believe that harmonised or coordinated controls would not be appropriate.

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?

We do not believe that parties should benefit from being treated as market makers unless they are prepared to take on the burdens inherent in this role: ie providing genuine liquidity even at times of stress. This may well not be possible for investors which seek to have flat positions at the end of the trading day: a genuine market-maker is prepared to carry a position and has the necessary regulatory capital to do so. We would note our view that the liquidity provided by most high frequency trading firms is of dubious value given that their model is to be flat overnight – any apparent liquidity is withdrawn automatically on a regular basis, as well as in moments of market turbulence.

Stub quotes appear to us a way of obeying market rules while flouting the spirit of those rules. They are therefore unwelcome and should not be permitted.

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.

If there is any requirement for a technological upgrade by regulators, we believe that the cost burden of this needs to fall on the shoulders of those firms whose activities lead to this requirement. This is the only way to ensure fairness among market participants. We believe that a simple way for this to be delivered would be to tax co-location charges.

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 believe that trading strategies which expressly intend the bulk of posted offers and bids to be withdrawn rather than fulfilled are unhelpful for disciplined markets where settlement failures are minimised.

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.

We believe that greater attention needs to be paid to the area of conflicts of interest generally. We believe in particular that proprietary trading activities may on occasions be inimical to client interests.

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?

We do believe that the current rules on market abuse on their face do encompass orders generated by modern technology, but we fear that the current narrow definition of those activities which fall foul of the market abuse regime is too narrow. We believe that on any natural understanding of language and appropriate market behaviour, trading activities which involve posting large numbers of bids and offers, the bulk of which are withdrawn – and were never intended to be fulfilled but were only placed to gain market knowledge – must be market abuse. These are phantom bids and offers and as their intent is never to be fulfilled, such phantoms seem deliberate attempts to take advantage of other market participants simply to the benefit of the party posting these phantom quotes. To be clear, we believe that this analysis extends beyond just flash orders, which we would strongly favour seeing banned; we believe active consideration needs to be given to regulatory intervention which goes well beyond just flash orders.

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

As discussed above, we believe that the process of making multiple bids and offers which are never intended to be fulfilled should be a focus for significant regulatory attention.

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?

We believe that fees and charges are a less appropriate step than a regulatory response using the tools of market abuse and disorderly trading rules.

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

We believe that this is a necessary step. We share the view reported in the paper that there has been a most unhelpful arms race in co-location whereby some investors have sought an advantage over their peers. Any such advantages are unhelpful to the proper functioning of the markets and so it is necessary for regulatory authorities to take any necessary steps to ensure that the benefits of co-location are available on a fair and non-discriminatory basis. We have seen it suggested that co-location charges are equivalent economically to market participants paying markets to delay information flows to other investors; clearly this would not be permitted by regulators. The natural conclusion of this analysis is that co-location needs to be made available on a non-discriminatory basis. As indicated above, we believe that a tax could be applied to co-location fees in order to fund an increase in regulatory costs which arises from the challenge of overseeing high-frequency trading.

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?

We believe that stress testing of algorithms is necessary and vital to ensure that they do not further disrupt the market. It seems appropriate to require market operators – which benefit directly from the trading activity generated by high-frequency traders – to provide the environments necessary to facilitate this.

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?

We have nothing to add to the comments above.