Alternative Investment Management Association

Mr. Werner Bijkerk
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Sent by email to market-integrity@iosco.org

12 August 2011

Dear Mr. Bijkerk

IOSCO consultation report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to comment on the International Organization of Securities Commissions' (IOSCO) Consultation Report on 'Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency' (the 'Consultation Paper').

Summary of AIMA's comments

- New market technology has led to improved execution speeds, efficiency, liquidity, price transparency and price reliability. This has resulted in greater participation in the markets.
- Algorithmic and high-frequency trading are not, themselves, trading strategies but are, rather, methods by which certain strategies can be carried out efficiently. Firms should be required to be registered and regulated by a market regulator because of the types of services they provide or because of the parties on whose behalf they trade, not because of their method of trading.
- Registered and authorised firms should have in place risk controls and risk monitoring programmes, as appropriate to their trading activities. In the case of algorithmic trading, such controls may include stress testing of algorithms against historic trading data.
- Circuit breakers and limit-up/limit-down systems could be introduced and harmonised across trading venues in order to minimise the likelihood of breakdowns in the systems of trading. Trading pauses should be as short as is necessary to attract normal buying and selling interests.
- Many firms which make use of algorithmic and high-frequency trading are already registered and supervised by market regulators. Existing regulatory regimes, as well as self-regulatory oversight by exchanges and market intermediaries, should be sufficient both to monitor algorithmic and high frequency trading and to catch abusive market activities.
- Co-location services should be made available by trading venues on a basis which is equal and fair to all market participants.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.

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AIMA's comments

AIMA believes that new market technology has led to significant improvements in the operation and efficiency of the markets, which in turn has led to greater price transparency and reliability. As a consequence, new participants have been attracted to the markets and liquidity has improved, leading to further reductions in transaction costs and narrower bid-ask spreads. In many instances, algorithmic and high-frequency trading is conducted as a result of legal best execution obligations, which require intermediaries to achieve the best possible results for their clients in executing trades. Best execution is measured in terms of many factors, one of which is the speed of execution.

Whilst there are risks associated (as there are with all trading methods) with the use of computer algorithms and, in particular, high-frequency trading, we believe that such dangers can be effectively mitigated by the use of appropriate risk controls at firms, by proper oversight of the markets by market regulators and by circuit breaker controls imposed by trading venues. The imposition of charges and fees on messages, cancellations or high order-to-trade ratios, or of minimum resting periods on bids/offers (an idea on which the European Commission has recently consulted), which forces liquidity providers to become market makers, is likely to effectively prohibit the use of algorithmic and high-frequency trading. Such a prohibition would be to the detriment of all market users, including those who do not conduct trading using computer algorithms, who benefit from the lowest prices when buying and selling instruments on trading venues and from having buoyant, liquid markets.

We provide detailed answers to the questions in the Consultation Paper in Annex 1.

Although not proposed in the Consultation Paper, other policy-makers around the world have discussed ways in which algorithmic trading can be slowed down, removing high-frequency trading from the market. They believe this may be an effective solution to deal with certain of the risks associated with, in particular, high-frequency trading. We believe this so-called 'grit in the wheels' argument is flawed and will unnecessarily and negatively impact the markets and their users. We provide further details of our thoughts on this argument in Annex 2.

Conclusion

AIMA supports IOSCO's important review of the impact of technological change on market integrity and efficiency and believes such a review provides national policy-makers with important considerations when designing appropriate regulatory regimes for the markets. Although new technology does not require a fundamental re-think about how parties trade in the markets and how market regulators oversee those markets, there are steps that market participants could be taking to ensure that technology does not create new risks which are unforeseen and are not properly mitigated.

We thank you for this opportunity to comment on the Consultation and we are, of course, very happy to discuss with you in greater detail any of our comments.

Yours sincerely,

Jiří Król
Director of Government & Regulatory Affairs

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Annex 1

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?
AIMA is of the view that the introduction of new technological developments in the market in recent years has contributed significantly to the creation of capital market conditions which have benefited all participants. New technology has allowed for improvements in execution speed, efficiency, liquidity and price transparency as well as price reliability. Each of these improvements has encouraged participation in exchange traded markets, as is clear from the published annual trading volume statistics of the major exchanges, showing significant year-on-year increases. Although the impact is felt most significantly in the largest and most liquid markets – equity and futures markets, in particular – new technological developments have led to improvements across a wide range of exchange traded asset classes and instruments.
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?**
The vast majority of AIMA's hedge fund manager members are fully regulated and subject to a range of prudential and conduct of business requirements in their local jurisdictions. For those proprietary trading firms, including those who use high-frequency trading, which are not currently subject to authorisation in their home jurisdiction, we believe that there may be a case for authorisation of these firms above an appropriate threshold. Currently, regulated firms through which such non-authorised entities trade (i.e., intermediary firms) have been required to exercise a certain amount of control over their clients, including monitoring their activities for potential market abuse and ensuring that their clients manage their risks to prevent distribution to the market. However, whilst we believe that it will be necessary for intermediaries to retain such suitably robust controls, it is likely that an appropriate level of authorisation and regulatory control by market regulators is warranted.
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?
Existing regimes in the major financial jurisdictions generally require regulated firms to have appropriate pre- and post-trade controls to manage the risks of their trading activities. AIMA fully supports such requirements, which benefit individual firms and ensure the safety of counterparties and the market. Managing risk is one of the fundamental responsibilities of a firm's governing board and the Board would be failing in its responsibilities to shareholders, investors or other beneficial owners if it failed to manage risk in a responsible way. We do not believe that a specific set of requirements is necessary for firms that utilise algorithmic trading or high-frequency trading. Each firm should take whatever bespoke measures are necessary to manage the risk

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created by that firm's individual business model and activities. As part of the prudent supervision of all regulated firms, we would expect market regulators to request and review firms' appropriate policies and procedures to ensure that risk controls are in place and that procedures are followed.

Firms which make use of automated trading are additionally subject to a certain degree of self-regulation by the exchanges and their counterparties. First, in most major financial jurisdictions, those firms which are members of an exchange are required to be regulated as investment firms, broker-dealers or credit institutions and are subject to scrutiny by their market regulators. Those firms which are not regulated entities may only gain access to exchanges via direct market or sponsored access, using regulated entities' membership of the exchange. In this instance, these firms currently are subject to oversight by the member, who is ultimately responsible for the conduct of trades conducted using its membership, including those of indirect participants. As discussed above, however, there may be a case for transferring some of the responsibilities for overseeing the trading of currently unregulated entities to market regulators.

Second, nearly all exchanges have a rule-book, which governs trading using their systems and sets limits on the scope of members' activities.

Third, in a large majority of cases, automated traders will be contracting with heavily regulated investment firms and credit institutions, who will impose a certain degree of control over their counterparties themselves to ensure compliance with their own requirements. All firms trading on an exchange, whether using automated trading or not, will be subject to either direct or indirect regulation by market regulators or the exchange and counterparties themselves.

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)?

AIMA supports requirements that reduce the risk of a breakdown in the systems of the trading venue that may impact the ability of the market to determine prices of listed securities. Such breakdowns, which generate disorderly trading, may arise from automated trading but may, equally, be the result of the interaction of orders placed by brokers manually. Therefore, if circuit breakers or limit-up/limit-down systems are designed in such a way as to prevent all disorderly trading, we would support these being mandated.

However, AIMA believes that any pause in trading should be for as short a period as is necessary to allow buying and selling interests to find a clear price and then allow the natural forces of supply and demand to come back into play, permitting investors to continue to place orders and execute their trading decisions.

Since certain markets are particularly interconnected, as shown on 6 May 2010 (the so-called "flash crash"), there is a case for harmonisation of proposed circuit breakers / limit-up/limit-down systems. As individual traders will often trade in multiple markets, including using automated systems, there is the possibility of trade disruptions in one market to be transferred to other markets. Harmonisation of proposals will ensure that equal protection is provided in all markets to control the spread of disruptive trading. For example, the US equity exchanges have recently proposed a joint NMS plan to introduce a common limit-up/limit-down proposal in response to the flash crash and perceived failings in their existing circuit breakers. Harmonisation of requirements also helps reduce opportunities for regulatory arbitrage. If circuit breakers / limit-up/limit-down systems differ, market users may be able to take advantage of related market conditions on two exchanges where different circuit break triggers or different lengths of trading pauses exist. Exchanges themselves may also try to compete for the 'lightest touch' requirements (e.g., the lowest trigger points or the shortest trading pauses), in order to attract business. This competition among the exchanges may be conducted to the

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detriment of market stability, unless harmonisation is required.

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?

As identified in the Consultation Paper, firms utilising algorithmic and high frequency trading strategies often act in a market making or liquidity providing capacity and, as such, are able to benefit from rebates from exchanges when they provide liquidity to the market. This is a valuable service to the market, which allows traders to have a wide variety of securities instantly available to buy or sell in the market at clear and transparent prices. It is proposed by some that these firms should be subject to further obligations, including the obligation to provide liquidity on an ongoing-basis. AIMA does not believe that imposing the suggested obligation is either necessary or appropriate and that it would, in practice, have a number of material adverse impacts. In the absence of providing any compensating beneficial rights, the imposition of this proposed obligation would, we believe, create an unlevel playing field, reduce competition, and consequently reduce liquidity and increase prices for investors. A number of firms would leave the market as there would be a requirement to make significant additional investments in technology, compliance, and other resources and, further, it would erect a barrier to entry for new participants – these are not desirable outcomes to create.

It should be noted that, in times of market stress, firms pursuing certain strategies using high frequency trading will tend to be more active and provide more, rather than less, liquidity to markets since there are more opportunities for these strategies to prove to be profitable in times of higher volatility and wider bid/offer spreads. Further, it is estimated that non-traditional market makers now account for up to 50% of the market making activities of some of the major exchanges and, thus, are significant liquidity providers.

If some mandatory minimum criteria for market makers are proposed, we believe that these should be subject to a full and detailed consultation to ensure that they do not create overly burdensome requirements, which would discourage potential market makers from offering this service and would perhaps, reduce overall market liquidity. It is likely to be desirable for all markets within a jurisdiction to be subject to common minimum requirements in order to avoid competitive distortion.

We agree that the use of stub quotes – orders placed well off a stock's market price to ensure no trades occur – should be prohibited. It has been shown that stub quotes played a significant role in the large drops in the value of stocks during the flash crash in 2010. We understand that, in the US, the Securities and Exchange Commission has already prohibited stub quotes and has, instead, introduced new requirements on market makers to continuously maintain two-sided quotations during regular market hours that are within a certain percentage band of the national best bid and offer. We believe this is a sensible approach to dealing with stub quotes, which should be taken up in other jurisdictions.

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.

It is unclear what improvements to specific regulators' surveillance capabilities are required to address modern trading techniques. The most important task for market regulators is to understand the new technology employed in the market and its impact across the board. Captured within most national regimes are extensive transaction reporting requirements that will allow regulators to take an overview of the markets and detect instances of market abuse. There may be a necessity to update systems to deal with the increased numbers of

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transactions that take place on modern markets, due to the introduction of new technology.

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?

The Consultation contains no substantive discussion of settlement indiscipline or settlement failures. We do not have any evidence that settlement indiscipline or failure is common in the market or is a particular problem which requires addressing in relation to algorithmic or high-frequency trading. We are not aware of new technology having either increased or decreased the instances of settlement indiscipline or failure. Where such instances do occur wilfully on the part of a market participant, these should be addressed through the appropriate market abuse regime. We would be happy to discuss this issue further with IOSCO, given more details.

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.

Conflicts of interests between firms that simultaneously conduct client-serving activities and certain proprietary trading activities are potentially significant issues. However, firms that conduct both services, in nearly all cases, have a powerful incentive and often a legal obligation to have strong controls in place to ensure that proprietary trading teams, aiming to profit directly from trading, are not able to benefit or trade ahead of their clients for whom they are placing trades (e.g., Chinese walls). Market makers will often be required to trade on a proprietary basis to manage their securities inventories, facilitating client trading. Where market makers are trading in this capacity, it is also important that certain controls are in place where conflicts of interest may arise. Where appropriate controls are not mandated by market regulators, they should be introduced.

Where a trading participant is a shareholder in a trading venue, there may be a conflict of interest if, under certain circumstances, that party is able to direct clients' trades to venues in which it has an ownership interest, to the detriment of those clients (i.e., it does not achieve best execution). Such conflicts of interest should be identified by the trading participant, notified to its clients and mitigated, where possible, as part of good regulatory practice and as is required in many jurisdictions. If there is abuse of a venue's trading systems to ensure that trading participants receive preferential prices or receive greater transparency on prices and volume, this should be considered market abuse and dealt with appropriately by the market's regulator. Best execution obligations should also be strong enforced by market regulators.

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 believe that the use of algorithmic trading, which is not a strategy itself but merely a method by which a trade is executed, does not create any new forms of market abuse. Many of the practices of market abuse or causing disorderly trading can be conducted equally via computer generated orders and by manual means. Where these activities occur, AIMA supports national regulators in their important work to combat market abuse and eliminate inappropriate trading strategies, wherever they occur.

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

We do not believe that any specific strategies of HFT firms raise particular regulatory concerns while many

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provide valuable liquidity to the markets or help reduce market prices and improve price discovery. If there are specific examples of strategies that IOSCO believe may cause concern, we would be happy to provide our views on those and, if we agree with those concerns, propose recommendations for national regulators.

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 do not believe that imposing fees or charges on messages, cancellations or high order-to-trade ratios is either appropriate or proportionate. Such proposals would effectively curtail or prohibit high frequency trading in the market. High frequency trading techniques inevitably result in a high rate of placed, cancelled and refreshed orders (any of which may, or may not, be executed as the order flow adjusts to rapid information signals, market conditions, and other factors in the trading environment). It is appropriate for the market that there should be frequent changes to quoted prices, albeit that new technology allows such changes (which, of course, historically have always taken place) to be implemented very rapidly. The consequent benefits to investors and other market participants of the increased liquidity and reduced spreads which result should not be overlooked. There are perfectly legitimate reasons for placing and subsequently cancelling orders given the developments in technology and the rapid speed of information signals. Placing orders which are never intended for execution is not a practice we believe is widespread among high frequency trading firms.

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

Yes. AIMA agrees that co-location services should be made available by trading venues on an equal and fair basis to all and recommends that transparency of both pricing and of the policy underlying the allocation of capacity by trading venues should be a requirement.

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?

AIMA believes that testing of trading algorithms may be an important element of the risk controls a firm using such algorithms have in place. Whilst it is difficult to simulate every possible consequence which a trading decision might have, it will be prudent for firms to try to better understand the impact of their trading strategies. It is unlikely to be necessary to require market operators to provide this service and it may also be that other parties could provide such a testing environment or that testing could be conducted in-house using historic and publicly available information on prices and volumes. Instead, it would seem that stress testing of trading algorithms is a way for trading firms to demonstrate to market regulators that they are managing and monitoring their risks. If this is the case, firms will seek out appropriate testing environments to test their algorithms. This may be offered by the exchanges as an additional service, paid for by the market users. For simple algorithms, significant testing may not be necessary and internal tests may be appropriate. For complex trades, testing of algorithms against a greater set of data, including data recorded during stressed market conditions may be necessary. It is unlikely to be possible to set a minimum set of requirements for testing, where testing is appropriate, but firms should instead conduct necessary testing to ensure good risk management.

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?

AIMA has no further comments on issues raised in the report.

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Annex 2

Addressing the 'Grit-in-the-wheels' proposal

Although not proposed by IOSCO, it has been mooted by some that one approach to the concerns over algorithmic and, in particular, high-frequency trading, is to slow the whole pace of trading down – referred to by some as the 'grit in the wheels' argument. We believe this is an extreme solution to certain perceived problems, which can be dealt with more effectively, in their entirety and without severely impacting the markets, using other policy options such as those we comment on above.

The main way of throwing 'grit in the wheels' is to impose a minimum resting period for all trades, such that a bid or offer placed on the exchange must remain there to attract buying/selling interest for a given period of time. Essentially, this prevents the high-frequency nature of trading as parties cannot place, withdraw and re-place bids and offers on a mille-second by mille-second basis. The proposal has been discussed in the US by the Securities and Exchange Commission[2] and recently in Europe by the European Commission, in the context of their review of MiFID[3]. Commentators in both jurisdictions have not supported the proposal.

Those in favour of this argument argue that having a minimum resting period would tend to reduce the risk of liquidity droughts by ensuring that parties cannot withdraw market liquidity in fractions of seconds during periods of volatility. Systemic resilience is ensured by preventing sudden dry-ups of liquidity, which drive prices to extreme highs or lows. Non-market makers likewise cannot take advantage of mille-second trades, many of which will not be executed, ahead of less-sophisticated traders who cannot react to sudden periods of volatility. They argue this increases market integrity and creates a lever play-field for traders.

Liquidity droughts and periods of extreme volatility are rare. The arguments in favour of 'grit in the wheels' solutions do not consider that for the vast majority of the time, during normal trading, the consequences of the solution will be widespread for all investors and market users. The inability to trade at high-frequency will reduce the volume of trades that can be done and will naturally reduce overall market liquidity. This in turn will lead to higher bid-ask spreads from market makers and increased transactions costs for all market users, both sophisticated and less so. By building inefficiency in to the markets, certain policy-makers are turning back the clock to a time before high-frequency trading and withdrawing its benefits, currently enjoyed by all.

Instead of throwing grit in the wheels, surely a better way to address these problems is by improving the machine. Circuit breakers allow markets to function normally right up to the moment where trading volumes become sufficiently volatile and then apply the brakes. By proper testing and sufficient oversight of algorithms used for trading, problems can be detected to prevent volatile feedback loops.

It should be noted that markets can be volatile even when the trades are not conducted at high-frequency and there are sufficient historic examples to show this. High-frequency traders in today's markets often increase liquidity in volatile markets, as wider bid-ask spreads provide new opportunities to profit from trades. The SEC in its report on the May 2010 flash crash[4] concluded that the cause of the volatility in the effected markets was not a high-frequency trader (as some suspected) but was caused by an errant order by a single mutual fund entered

[2] SEC Concept Release on Equity Market Structure, 14 January 2010.
[3] European Commission consultation on the Review of the Markets in Financial Instruments Directive (MIFID), 8 December 2010.
[4] SEC and CFTC report: Findings regarding the market events of May 6, 2010, published 30 September 2010.

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via computer (at non-high frequency) that set its trading specifications with reference to trading volumes but without considering price or time. High-frequency and other traders were involved and their trading decisions became based on the flawed but exceptionally large trading volume of the securities, interacting with perfectly reasonable market algorithms. The consequences were allowed to continue unchecked and became exacerbated by (i) poorly designed exchange circuit breakers which did not trigger and (ii) the use of 'stub' quotes, which allowed certain trades to be conducted significantly off normal pricing, including as low as 1c and as high as $100,000. If these problems had been solved, which in the US, for example, they now are, the volatility would not have been noted except by the most ardent watchers of the market.

Those who believe in the 'grit in the wheels' argument state that there is a trade-off between the benefits of high-frequency trading and market stability. They argue that less efficient markets but reduced effects in times of crisis makes it the preferred outcome. We would argue that it is possible to have the benefit of high-frequency trading and, via other policy options, improved systemic resilience without the need for this trade off. Further, instead of seeking to tackle only the actions of certain participants in the market, IOSCO and national policy makers should focus their attentions on broader market interactions and market structures in the world of decentralised electronic trading with competing market centres.

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