WORLD FEDERATION OF EXCHANGES

12 August 2011

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

Submit by e-mail to market-integrity@iosco.org

Executive Summary :

The WFE especially welcomes this IOSCO public consultation given the importance of innovation for markets, and the need for its greater understanding.

Exchanges believe that they can provide useful insight thanks to their front line role in monitoring, detecting and preventing market abuse, as well as in developing technology.

The WFE appreciates the difficulty to deal properly with microstructure phenomena in isolation without considering the overall market structure. The absence of a level playing field in regulation among trade execution venues is one example.

This level of fragmentation impairs the ability for listed companies to understand the market in their shares. It weakens the trust in capital markets; it diminishes the capacity of exchanges in raising capital to promote economic growth.

Mr. Werner Bijkerk,
Head of the Research Unit
IOSCO

Dear Mr. Bijkerk,

The World Federation of Exchanges ("WFE")[1] welcomes the IOSCO Technical Committee's Public Consultation on *"Regulatory Issues Raised by the Impact of Technological Changes on*

[1] WFE is a non-profit trade association of publicly regulated stock, futures and options exchanges operating worldwide. The Federation contributes to the development, support and promotion of organized and regulated securities and derivatives markets. WFE is an affiliate member of IOSCO.

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Market Integrity and Efficiency," along with the accompanying letter Technical Committee Chairman Masamichi Kono addressed to Financial Stability Board Chairman Mario Draghi. WFE takes this opportunity to comment on the direction in which regulators may advance on several of the interconnected issues set forth in the Consultation Report.

WFE publicly endorsed the IOSCO Principles of Regulation many years ago, for the evident reason that they set out a common framework for the regulated portion of the world's financial system. This is also why WFE joined IOSCO in 2010: it was time for exchanges to be expressing their support even more publicly and strongly for a commonality in the workings and underpinnings of the world's exchanges. The evident interest we have in doing so is promoting ever greater flows of business across borders, for initial and secondary offerings as well as for daily trading.

Member exchanges will be answering IOSCO directly with comments, which should provide context and depth on these matters from the perspectives of individual regulated market operators. *This Federation letter should be read as a complementary group view, though one which perforce does not reflect the exact views of every exchange group member, or their unanimous opinions.* The 52 member exchanges of this Federation are quite diverse in their operations, reflecting their varying market environments.

Introduction – commonality *and* diversity

The business conducted on world's regulated exchanges is dominated by two inter-related subject areas, technology and market policy, particularly regulation and standards setting. This Consultation Report unites these two broad areas: for that reason, WFE agrees that a global review of the state of play in 2011 represents important stock-taking for capital markets authorities.

Equally, it is significant for the world's public marketplaces that G20 leaders meeting in Seoul late in 2010 requested an examination of the quality of transactions taking place as well as a consistent implementation of global standards in a way that "ensures a level playing field, a race to the top and avoids fragmentation of markets…". WFE believes that one key to advancing the world's future prosperity will be the success of G20 initiatives, based on the translation of those initiatives into laws that will then be evenly implemented across the constituent countries. Since 2007 with the first difficulties affecting financial markets, the Federation's chairman and secretary general have written and called on the Financial Stability Board, offering whatever expertise the regulated exchange environment had to decision-makers

WFE has member exchanges in all countries of G20, before which IOSCO is an authorized capital markets spokesperson.. Nevertheless, attention must be paid to the fact that the marketplaces across WFE are extremely varied. So are the technical bases of their trading systems. In addition to the diversity of technology, legal systems and rules vary, logically just as much as the underlying technology does. For these reasons, WFE's letter must perforce remain general, leaving aside the diverse views that industry leaders have on each of the topics forwarded by IOSCO, and resting on what is common to each and every of our members: the management of efficient, transparent, integrated and reliable markets where investors enjoy the highest level of protection and issuer companies get funding to help economic growth and job creation

The very real diversity characterizing the world's securities and futures exchanges does not diminish the importance of the question raised by G20, or the value of this well written Consultation Report. Rather, it implies to WFE that together with IOSCO in the G20 environment, it must push more rapidly towards broader and deeper convergence in the way exchanges do actually function. Until much greater success in commonality of practice is achieved, the global issues raised by IOSCO in this Report on behalf of G20 are best and most practically reviewed jurisdiction by jurisdiction.

As to the question of how public, regulated exchanges today manage the questions of integrity and fairness, WFE notes in particular Technical Committee Chairman Kono's intention to put macro-structure matters on the IOSCO review agenda. In our view, appropriate and effective regulatory responses to such matters as IT, risk controls, surveillance, fee structures, collocation and the like cannot be answered in sufficient depth without that overarching question of market structure itself.

Remarks on the existing state of the markets

The descriptions of trading in chapter 2 of the IOSCO Report appear accurate insofar as they set out in general terms trading activities in many of the larger marketplaces in the North Atlantic world, even though this overview would have to be fine tuned to be applied to other jurisdictions.

It is important to note that the official investigation into the 'flash crash' concluded the activity of HFTs was not the cause.

The accurate description of the *flash crash* included in the report shows, from WFE's point of view, that in a fragmented environment, trading in its entirety is not happening in tandem at all times; price discovery is no longer a unified event or movement among all actors. With so many varied institutions following their own trajectories in the same common space, in hindsight it is not hard to see how this happened.

Related to this, there is evidently a question of rigorous surveillance of the marketplace, as is the remit of exchanges and public authorities. If SEC and CFTC had to spend several months poring over massive data across all these trading entities to see where and what the "trigger event" for 6 May 2010 may have been, that might imply some gaps in daily live surveillance. Exchanges have the ability to survey only those orders which pass through their trading systems, but that in the US and EU that is now far from being the entire marketplace.

Finally, the flash crash underscores some of the changes in the contractual and economic relationships stock exchanges have with their issuers in the sense that the trading activity in a given security is far less visible and understandable. Corporate treasurers have a more difficult time in these conditions in assessing investor interest in existing securities, diminishing their ability to read the marketplace appetite for possible further rights issuance, and so weakening the economic function of the public marketplace in the capital formation process.

Remarks on high frequency trading (HFT)

Exchanges, like every other segment of the financial system, have experienced significant adverse changes and stresses in their daily operations post-2007. Yet even in this difficult commercial environment, they have continued to advance in their business development, including by taking advantage of many new technologies. Unlike other parts of the world's financial system, they have functioned relatively well on a daily basis, and have not required the urgent state aide that many of their fellow financial actors did.

At present, there is no universally agreed upon definition of HFT. HFT is not a single strategy, but rather a set of technological arrangements employed in a wide number of strategies.

Many, though not all WFE member exchanges, have advanced in enabling clients to use high frequency trading techniques, and have established trading centers with collocation offered. Order execution speed is of the essence to many trading strategies; as ever, the public exchanges have to accommodate many kinds of user requests at any one instant, with the obligation to be as responsive as possible in terms of providing for the fairest treatment one can devise. Exchanges have adapted their surveillance capacity in tandem with the increase in speed. For example, some of our member exchanges have messaging policies which monitor for excessive orders, credit controls to ensure that firms have capital to stand behind their trades, and surveillance tools to identify potential trading abuses including cross trading and wash trades.

The first point to make in favor of the advent of HFT is that it brings liquidity to marketplaces whose systems have been adapted to allow for it. This is acknowledged in the IOSCO Report[2]. This is especially welcome, in that HFT has provided for market pricing at a time when so many other investors have left the central marketplace entirely post-2007, presumably because of losses or redeployment of capital, or else to trade on other venues.

It is hard not to notice the acceleration of HFT as a proportion of public market business as having coincided with three major events: the crisis of complex OTC derivatives, the collapse of Lehman Brothers, and the implementation of MiFID and Reg NMS. The advance of HFT has helped fill the void created by a financial crisis in the North Atlantic world of a severity not seen in decades; and of forced breaking apart of the central marketplace for exchange-listed securities, as mandated by law and put into effect by the rules written by capital markets regulators.

Exchanges as businesses and providers of a public good cannot just stand by in the face of such events: it is a fundamental goal of an exchange operator to encourage trading interest. To do so, clients and exchanges had every interest in upgrading technologies to draw in orders; the tradition of constant evolution of technology stretches back several centuries[3]. Given the scope

[2] IOSCO Technical Committee Consultation Report: "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency," page 24.

[3] Michael Gorham, "The Long, Promising Road to Screen –based Trading," in Larry Harris, general editor, Regulated Exchanges: Dynamic Agents of Economic Growth, Oxford University Press, 2010.

of the financial collapse and the breaking apart of key financial centers, it is indeed remarkable that world-wide trading value did not fall more in these past several years.[4]

HFT has positively impacted market quality and the amount of liquidity present on regulated exchanges. A common misunderstanding asserts that HFT must be resulting in higher levels of settlement failure. High-frequency traders normally show very high settlement efficiency as they are flat at the end of the trading day. Unsubstantiated regulation of HFT could adversely affect the liquidity of trading venues and their innovation.

The IOSCO Technical Committee raises questions about HFT that are also on the minds of exchanges operators. These relate to fairness of access, cost of the new technologies, the integrity of the marketplace, and risks to the resiliency and stability of markets. From the experience of member exchanges and their discussions about HFT in the Federation's meetings, there has been a constant weighing of advantages and drawbacks of this new technology. It is their assessment that the added liquidity provided by HFT is the greater good, and that the other risks are expressly identified in order to be minimized to the extent a human institution can.

Remarks on regulatory tools

The IOSCO Report then elaborates the regulatory recommendations made for halts, dark pools, direct market access, and the like. WFE reiterates its support for IOSCO's work, because it is profoundly in exchanges' interest to maintain fairness and integrity of the marketplace. The future of the industry depends on it.

WFE supports the assessment stated in the IOSCO report that "it has established a coherent framework of regulatory tools for competent authorities to consider and implement as they deem necessary."[5]

Concerning possible future actions to be taken by IOSCO in technological changes in the marketplace, WFE limits its remarks to the level of "market operator" and "market structure."

As concerns the considerations posited for market operators, all points would be worth reflection in a public inquiry – with the notable exception of exchanges' commercial arrangements. As WFE sees matters, tariffs are a matter for the exchange to determine with the marketplace, whether on possibly establishing charges or fees on messages as noted in this Report or on any other matter. The best way regulatory tools can work in this field is guaranteeing a level playing field where competition is carried out on a fair basis.

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[4] In USD billions, equity market capitalization of the member exchanges at year-end were: 50 650 at end 2006; 60 855 at end 2007; 32 584 at end 2008; 47 782 at end 2009; 54 954 at end 2010; and 56 589 at end-June 2011. Against this background, the value of equity trading in exchanges' electronic order books only was: 70 034 for 2006; 112 968 for 2007; 114 147 for 2008; 61 372 for 2009; 63 078 for 2010; and 32 182 for the first half of 2011.

[5] IOSCO Technical Committee Report, page 38.

As concerns the four broad questions raised for future market structure review, WFE would support IOSCO leading public reviews of all of them:

- The balance between encouraging competition among venues and promoting the use of transparent, on-venue trading;
- The value of "flash orders" for the marketplace;
- Improving market surveillance by taking into account the needs of different market structures;
- Analyzing how existing market manipulation rules and laws apply to computer-generated orders.

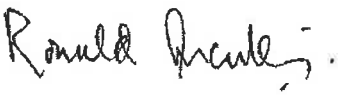
Conclusion

WFE reiterates its recent recommendation to IOSCO: to get a more satisfactory and longer-lasting outcome on market policy questions, it would be better for IOSCO to approach these matters using a holistic approach, setting the micro-structure issues within their broader macro-structure context. Piece by piece reviews will not get exchanges or their supervisors far enough in restoring and maintaining the integrity of the marketplace and its quality of fairness for issuers, investors and intermediaries. Without that restoration, it is hard to see how this segment of the world's financial system can meet its full potential in contributing to the rebalancing of the world's finances that lies ahead. The World Federation of Exchanges notes with satisfaction Technical Committee Chairman Kono's reference to such work in his letter to FSB Chairman Draghi.

The subject matter raised in this IOSCO Technical Committee Report serves as an excellent and comprehensive basis for the kinds of bilateral work that needs to be done jurisdiction by jurisdiction.

Together with the local authorities, the exchange operators can review the best balance between the greater liquidity technology can afford and optimum fairness for all those trading.

Sincerely yours,



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WFE Chairman
Chairman of Hong Kong Exchanges and Clearing

Thomas Krantz
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Cc: WFE Board of Directors

Annex:

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