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Subject: **IBFed's reflections on high frequency trading**

Dear Ms Bergsträsser,

The International Banking Federation ('IBFed') is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the European Banking Federation, the Japanese Bankers' Association, the China Banking Association, the Indian Banks' Association, the Korean Federation of Banks, the Association of Russian Banks and the Banking Association South Africa. This worldwide reach enables the Federation to function as the key international forum for considering legislative, regulatory and other issues of interest to the banking industry and to our customers.

Against the background of the ongoing debate over the possible regulatory response on how to regulate high frequency trading (HFT), the IBFed would like to share with you the following reflections[1].

Background and definitional issues

1. IBFed members share the view that the **historical emergence of HFT and HFT firms is a reaction to market and regulatory developments**. The implementation by exchanges of computerised communications permitting electronic dissemination of financial information - notably prices - coupled with the creation and growth of all-electronic alternative trading systems, allowed investment firms using automated computer

[1] This IBFed letter was drafted not having seen the recently published IOSCO consultation report entitled "Regulatory issues raised by the impact of technological changes on market integrity and efficiency". Whilst a fair amount of the issues raised by IOSCO are addressed in this letter, the latter should not be considered a proper response to the IOSCO consultation.

programmes to execute orders in a way that has led to increasing competition (i.e. lower trading costs) and execution quality (i.e. narrower spreads). HFT is, therefore, one of the outcomes of the ongoing evolution in trading technology.

2. IBFed members believe that markets, the regulatory community and academia are arriving at operational definitions as to what HFT is (and, conversely, what HFT is not). Fundamentally, HFT can be defined as a **form of automated trading implying speed**. As a result, it is the view of IBFed members that:

   - HFT is not a trading strategy. Trading strategies are a predefined set of rules for making trading decisions. Rather, HFT is a method to implement a predetermined trading strategy. As an execution method, the use of HFT makes sense as an instrument for market making and arbitrage (e.g. passive rebate, event, statistical) strategies.

   - HFT is a subset of algorithmic trading. Algorithms typically determine the timing, price, quantity, and routing of orders. In HFT execution, large number of orders - usually fairly small in size - are sent into the market at high speed, enabling round trip execution times measured in micro-seconds.

   - Despite the relatively high investments that have been required to develop and be able to offer HFT services, firms today can, in principle, furnish themselves with the developed trading technology that would allow them to provide this service. In other words, access to HFT seems to be non-discriminatory.

Order of magnitude

3. IBFed gives heed to available research pointing out that **HFT represents a significant part of trading volumes**, not only in the US and the EU but also in Asia[2]. The high proportion of HFT is most likely due to its profitability and relative success, despite the ongoing economic recession.

Regulatory concerns

4. From a regulatory perspective, the IBFed considers that attention on HFT should be focused on (i) how it impacts **liquidity and/or price formation** in the market; (ii) whether it affects the market's broader **integrity and stability**, including during periods of high market volatility; and (iii) whether it may **unfairly disadvantage some market participants**.

5. With regard to liquidity, most participants believe that HFT firms add liquidity to the market that would otherwise not be available and that, as a consequence, they help narrow bid-offer spreads, thus making trading and investing cheaper for other market participants.

[2] The Bank of England estimates that HFT accounts for around 70% of all equity trading volume in the US, 40% in Europe and 5-10% in Asia.
http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf

6. On price discovery, the Federation would like to mention that research[3] has found that HFT firms add substantially to price formation as they quickly detect anomalies in market prices and execute against them. In Europe, for example, HFT may help mitigate the liquidity fragmentation brought about by MiFID.

7. On possible **risks to the integrity and stability of the market**, the IBFed believes that:

   - No evidence has currently been provided suggesting that HFT *per se* has an impact in the triggering of a market volatility episode or that high frequency traders push stock prices around. If a stock price were truly "overreacting" to a large buy order (i.e. creating volatility) or was otherwise needlessly pushed around by high frequency traders, it seems that other traders (high frequency or others) would detect this "overreaction" in the stock price and have a market incentive to push the price quickly back down to fair value.

   - Regulators should not backtrack on existing technology. The potential imposition of any requirements for orders to remain on the order books for a minimum period of time (i.e. requirements on order persistence) should, in any case, be preceded by a thorough cost and benefit analysis.

   - Specific activities of HF traders such as the order execution ratio should be, however, subject to thorough investigation to ensure that no market-abusive strategies be undertaken through the use of technology. Furthermore, a concern exists in some parts that certain market participants pursuing directional strategies are using HFT with a view to being able to influence the curve of the market. If it appears that certain strategies are not legitimate, involve market abuse, or pose a risk to the system, regulatory and/or supervisory corrective action should be taken after thorough study of the facts and the likely impact of proposed actions.

   - More work is necessary to mitigate the potential impact that HFT firms may pose on market stability with regard to venues' bandwidth consumption and/or their systems' capacity. Ensuring an optimal execution system is, however, the responsibility of trading venues, being in the latter's interest to establish trading rules and systems that contribute to efficient and robust markets.

8. On the potential of HFT (alone, or in association with the provision of other services) to **disadvantage some market participants unfairly,** the IBFed notes that the successful implementation of a form of automated trading that implies speed relies not only on IT investment and adequate algorithm design but also on access to co-location (i.e. installation of trading engines directly adjacent to the markets' own infrastructure) or access to exchange trade data feeds. The IBFed calls upon regulators to ensure that access to co-location and/or trade data feeds is appropriately open to all interested traders.

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[3] "High frequency trading and its impact on market quality" Brogaard (2010). http://www.futuresindustry.org/ptg/downloads/HFT_Trading.pdf

HFT firms as market-makers

9. Given the amount of liquidity HFT firms are able to deploy in the market, some argue that these firms play a similar role today to that played by market-makers in the past and that they should, therefore, be subject to regulation requiring them to provide liquidity on an ongoing basis. It has been argued that the lack of market-maker requirements creates a liquidity vacuum when markets are stressed. In the view of the IBFed, a move to treat HFT firms as market-makers should take into account the following considerations:

   - The **emergence of HFT has modified the traditional business model of market-makers**. Exchanges historically relied on market-makers to provide bids and offers for investors to trade against. Profit was based on the spread. However, in exchange for meeting stricter obligations, market-makers were generally given advantages over other market participants (e.g. preferential access to the markets, lower fees and informational advantages). Such advantages act like subsidies and come at a substantial cost for investors as they degrade competition and raise barriers to entry for new participants.

   - The potential **imposition of market-making obligations on HF traders** (e.g. an obligation to post orders for a specified number of shares at certain prices (so as) to improve liquidity) **may not prove effective** in the face of overwhelming market moves. Furthermore, the IBFed considers that forcing HF traders to become market-makers may have a detrimental impact on the level of liquidity in the market as the benefits of the liquidity they currently provide voluntarily might disappear.

   - Regulatory **repair to make equity trading more resilient could prove more effective if focused on alternative, well-designed safeguards**: (i) proper risk controls and arrangements to mitigate the risk of errors generated by automated trading leading to disorderly trading; (ii) better and clearer rules for cancelling errant trades; and (iii) an adequate regulatory treatment of stub quotes.

   - Furthermore, rather than establishing rigid requirements that could potentially drive HF traders off the markets, **trading venues could use incentives (e.g. rebates) for liquidity provision in times of high volatility** thereby stabilising the price formation process.

HFT firms authorisation and supervision

10. Industry would consider a **carefully designed supervisory programme that does not inhibit the ability of HFT firms to serve their customers**, always keeping in mind the need to demonstrate that the proposed regulatory structure is an improvement over market discipline. Any authorisation would be conditional on the fulfilment of some organisational requisites, and upon the introduction of risk management obligations and proportionate capital requirements, that should be agreed and implemented on a globally coordinated basis.

Conclusion

11. The Federation supports the recommendation that issues around automated and high frequency trading be given careful consideration. The Federation notes that **no conclusive**

evidence has currently been provided that demonstrates HFT is detrimental to the market. Rather, there is recognition that HFT could benefit the market by increasing liquidity, reducing bid-ask spreads, and enabling market participants to obtain best execution.

12. In this light, **any rules to regulate the provision of HFT or HFT firms themselves should be flexible and dynamic, in order to adapt to changing market conditions quickly**. This, with the overriding objective of preventing market abuse, and ensuring the stability and integrity of financial markets, while avoiding the hindering of technological progress or unduly restricting competition.

We would like to thank you for the consideration of these reflections and are looking forward to learning about IOSCO's next steps with regard to High Frequency Trading issues.

Yours sincerely,

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