efama

European Fund and Asset Management Association

EFAMA reply to IOSCO Consultation Report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency

EFAMA[1] is grateful for the opportunity to respond to the IOSCO Consultation Report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency.

EFAMA agrees that technology's increasingly important role in financial markets and its impact on market integrity and efficiency should be taken into account by financial regulation. However, technology is an important tool for investment managers to fulfil their fiduciary duties towards their clients, and its benefits should be recognized. Furthermore, it is important that regulation on technological changes be targeted at the correct level, including rules for markets and market operators and not only aimed at market participants.

Q1 What impacts 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?

Major financial markets have witnessed an increase in fragmentation (in the EU, after the implementation of MiFID in 2007) with the creation of new trading venues and the expanded use of "dark pools". High frequency trading (HFT) has also emerged.

EFAMA members are institutional investors usually trading in large volumes while attempting to reduce price impact. Many among our members consider that HFT is not conducive to their traditional execution strategies and the general decline in order size has increased their concerns about displaying orders on lit markets. Together with market fragmentation, this has been the main driver for the increased use of "dark pools"[2], which are seen by many EFAMA members as beneficial to institutional investors and their clients, as they enable the search for liquidity while reducing the risk of negative price distortions.

For some EFAMA members, on the other hand, data transparency is the key issue, both to be able to obtain and prove best execution, and to value portfolios. Speed of execution is far less important than the negative impact of fragmentation of market information and the lack of transparency for some markets.

[1] EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 56 corporate members approximately EUR 13.5 trillion in assets under management, of which EUR 8 trillion was managed by approximately 53,000 funds at the end of 2010. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds.

[2] Which in the EU are not subject to pre-trade transparency requirements but provide post-trade transparency

NEW ADDRESS AS OF 8 JULY 2011: rue Montoyer 47, B-1000 Bruxelles

☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

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?

EFAMA members believe that some common regulatory standards should apply to all market participants, including proprietary trading firms. However, there are different opinions on how that goal should be reached: some agree that all proprietary trading firms should be registered/authorised, albeit without specific regulatory requirements for firms such as HFTs. Dedicated proprietary traders should be registered whether or not using sponsored access, but also any firm with direct access should be registered. Furthermore, regulators should have knowledge of the identity of systemically important firms and of their activities, and all trading firms should be required to transaction report.

Other members are of the opinion that proprietary trading firms (including HFT firms) should not require an authorisation by regulators, but a simple registration for firms beyond a certain threshold (defined in terms of amount invested) would be sufficient, as proprietary traders only invest their own money and the main players are already regulated and authorised. However, the application of stringent market abuse regulation to all market participants and enforcement are crucial. Regarding the differentiation between direct market members and customers with DEA, these members consider that direct market members require an authorisation, while for customers with DEA a mere registration is sufficient, as the intermediary is already authorised.

Finally, some members support the introduction of a broad definition of automated trading, with the regulatory requirements capturing all players and with HFTs as a sub-category of the wider categorisation of automated trading. They consider that automated trading firms should have robust control systems, but doubt that HFTs should be treated as market makers by market operators to ensure they provide liquidity on a continuous basis. Where sponsored access exists, the regulatory responsibility should fall on the intermediary in question, which should be subject to a broad and consistent set of requirements applicable across all trading entities.

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?

Regarding pre-trade controls, some EFAMA members consider that that it would not be practicable for firms to register their algorithms with regulators, and that there is already sufficient economic motivation for firms using algorithmic trading to ensure appropriate monitoring and testing. Risk management provisions cover such activities, but tailored and more specific obligations could be introduced to provide further guidance.

Other EFAMA members, on the contrary, consider that algorithms should be notified to supervisors. Additionally, they would support strong risk control requirements (e.g. controls to prevent 'fat-finger' orders) to ensure that algorithms are used appropriately, based on the size, motivation, and potential impact of an order. 'Speed-bumps' which disrupt automated momentum following within an automated trading agent past pre-defined thresholds could also be considered.

From a post-trade perspective, some EFAMA members believe that the creation of consolidated audit trails would be beneficial, although the confidentiality of the client's order flow must be guaranteed and the monitoring mechanism must be complete, tracking executions as well as information regarding order cancellations and amendments.

Some among our members stress that two aspects are crucial: clear responsibilities for supervisors in market surveillance and data reporting by registered entities, to enable daily direct and permanent access by regulators to market data. They should be combined with circuit breakers on all markets.

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)?

EFAMA supports the mandatory use of trading control mechanisms such as circuit breakers and limit-up/limit-down systems.

A large majority of EFAMA members support a high degree of harmonisation for such controls across trading venues (possibly through the issuance of global guidelines in this area), in order to restore order in the markets as quickly as possible and to avoid unfairly favouring some market 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?

Market maker schemes offered by trading venues should be subject to mandatory minimum criteria to be determined by the trading venues alone. However, some of our members consider that such criteria should be submitted to the relevant regulator.

We agree that stub quotes as defined in the Consultation Report should be banned. The question arises, however, of what constitutes an acceptable quote for market makers: some among our members suggest that quotes should be provided within an acceptable tolerance band from the National Best Bid Offer (in the US) or its equivalent in other markets.

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.

Various proposals have been made by our members:

- Submission to regulators of price limits by trading venues and market operators
- Registration of proprietary trading firms and DEA customers
- Better direct access to market data by regulators, as in many countries national supervisors are currently relying on market operators and/or SROs – creating the risk of delays during market disruptions.
- Regulators need to be aware of which firms are systemically or locally important and supervision could be strengthened by better analysis of transaction reports.
- Market abuse regimes could be enforced if regulators suspect that participants are misleading or manipulating the market by the placing and near immediate cancellation or orders.

If the costs for developing and operating appropriate market monitoring capabilities rise due to the impact of technological changes, it would be appropriate to have some participants shoulder a larger proportion of the cost of maintaining this infrastructure. For example, to ensure fairness higher costs could be borne by participants who generate more messages than a reasonable threshold level, by registered/authorised entities, by trading venues/market operators as well as customers with DEA.

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?

EFAMA has no direct information on the causes of settlement indiscipline and failures. Some of our members consider that shortening the settlement cycle could be helpful, while others support additional transparency around failure rates, for example regarding the duration of a fail, the size of the fail, and an indication whether the fail is the result market making activity.

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.

The above-mentioned conflicts of interest require robust and appropriate mitigation policies for all market participants.

Some EFAMA members consider that in the European Union the MiFID regime could sufficiently address the management of conflicts of interest of investment firms. However, appropriate supervision and enforcement are key 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?

Existing laws and rules on market abuse and disorderly trading usually cover computer-generated orders and are probably still relevant, but could be reviewed in view of recent market developments and a more automated trading environment. However, it is important that existing rules look at the impact of algorithms, rather than presuming some mental capacity that is hard to apply to computer-generated orders.

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

For the buy-side it is difficult to evaluate the full impact of HFT strategies due to the lack of data. Strategies that are designed to profit from abusive and manipulative disruption of the integrity of the market are of paramount concern (i.e. the so-called 'quote stuffing' and 'momentum ignition' strategies). The high order cancellation rate characteristic of HFT firms is a key concern for our members.

In order to determine whether HFT firms' behaviour is manipulative, regulators must improve their ability to monitor markets at the level of today's trading velocity and sanction abusive behaviour appropriately.

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?

Some among our members recommend that regulators and/or market operators consider whether a small charge should be applied when cancellation rates are excessively high.

Other EFAMA members have differing opinions on the imposition of fees on messages, cancellations or high order-to-trade ratios: some are not opposed, while others consider that it would not be appropriate for regulators to intervene in the commercial pricing policies of trading venues: imposing fees on high order-to-trade would be detrimental to overall liquidity and bid/offer spreads, as it would effectively act as a tax on HFT participants and remove them from that market.

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

Yes, EFAMA believes that market operators should be required to make their co-location services available on a fair and non-discriminatory basis.

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?

A majority of EFAMA members does not believe that market operators should be required to provide testing environments to enable participants to stress test their algorithms, as participants already do their own extensive stress testing. Furthermore, some consider if the

requirements were overly onerous in this area they could stifle innovation and/or responsiveness of the development of algorithms by brokers, and stress testing algorithms could give a false sense of security as extreme market events such as the US Flash Crash and periods of extreme volatility would be difficult to produce in a test environment.

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?

Many EFAMA members do not support minimum order resting times which would disrupt their trading and execution, introduce inefficiency into the market and provide little overall benefit to the market. 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.

We hope our comments will be of assistance to IOSCO and remain at your disposal should you have any questions.

Peter De Proft
Director General

11 Augsut 2011

11-4058