The Pulse of Finance

Newedge

BY E-MAIL

August 12, 2011

Mr. Werner Bijkerk
International Organization of Securities Commissions ("IOSCO")
Calle Oquendo 12
28006 Madrid
Spain
Market-integrity@iosco.org

Re: Public Comment on Consultation Report: Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency/Newedge Group SA ("Newedge")

Dear Mr. Bijkerk:

Newedge appreciates this opportunity to comment on IOSCO's Consultation Report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency ("Report"). Newedge refers to Newedge Group SA and all of its global subsidiaries. Newedge has been quite active over the years, both in Europe and elsewhere, in working with regulators to develop rules and regulations designed to strengthen our financial markets. In Europe, Newedge has provided input to, among others, the European Commission ("EC"), the Committee on European Securities Regulation ("CESR") the European Securities Markets Authority ("ESMA") and IOSCO in connection with the formulation of various rules and initiatives. Given our broad experience across asset classes as both an executing and clearing broker – including securities, futures and OTC derivatives – we feel we are strongly positioned to provide such input.

In this comment letter, we will address a number of IOSCO's specific questions relating to high-frequency trading ("HFT"). However, before addressing these topics, we set forth below certain fundamental principles relating to HFT that we have consistently advocated, and which we believe regulators should abide by in establishing rules on this topic. These basic tenets are.

- HFT has had, in general, a positive impact on today's markets, including increased liquidity, lower spreads, lowered transaction costs and, in many cases, decreased volatility.

Newedge USA, LLC
630 Fifth Avenue
Suite 500
New York, NY 10111

TEL 646 557 9000
FAX 646 557 8480

A subsidiary of Newedge Group
Member SIPC and FINRA

www.newedgegroup.com

- The costs, responsibilities and obligations associated with monitoring and controlling the risks of HFT should be shared equally by all registrants that enjoy the benefits of such trading, including exchanges and other market centers.

- Addressing and resolving conflicts of interest presented by market intermediaries that trade electronically on both a customer and proprietary basis must remain a high priority of regulators.

- Automated pre-trade compliance and risk filters are an important, if not the most important means of controlling the risks of HFT. Such filters should be mandated by regulation, harmonized across markets and developed by market centers so as to promote consistency and avoid a "race to the bottom" among brokers. "Naked" direct market access should be banned.

- Co-location facilities and the transmission of market data must be regulated, and made available to market participants on a fair and transparent basis.

- Regulators must establish definitive and transparent rules relating to clearly erroneous transactions. Such rules should provide, among other things, that trades executed at prices that fall inside of pre-set numerical guidelines (i.e., "no-bust" zones) will not be broken absent a compelling public interest to the contrary.

- HFT customers accessing markets through brokers should not be subject to separate registration and reporting requirements. However, such customers should be: subject to anti-fraud, anti-manipulation and anti-disruptive trading rules; required to provide relevant information to regulators promptly upon request, and; required to establish internal procedures and controls.

- Fraud and market offenses relating to HFT (such as momentum ignition, layering, etc.) must be rigorously prosecuted by regulators. Regulators must develop the expertise and procure the systems necessary to monitor HFT.

BACKGROUND

1. Newedge

Newedge, which is one of the world's largest brokerage organizations, offers its customers clearing and execution facilities across multiple asset classes including futures, securities (fixed income, options and equities), FX and various OTC instruments.[1] Newedge maintains offices in over 15 countries, and is a member of over 85 exchanges worldwide. As of June 2011, Newedge

[1] Newedge is a 50%-50% joint venture between Crédit Agricole CIB and Société Générale, headquartered in Paris, France, and all of its worldwide branches, subsidiaries and other units.

had an estimated global market share in listed derivatives of 11% (clearing) and 11.9% (execution), and over Euro 50.8 billion of client assets on deposit. Newedge was ranked among the top brokers on most European exchanges for both clearing and execution volume as of the end of 2010. Newedge's primary function is that of a broker; i.e., to execute and clear customer transactions across multiple asset classes on an agency or back-to-back principal basis. Newedge conducts very little proprietary trading, and then generally only as a hedge in connection with the facilitation of customer orders.

Newedge's clients typically are brokers, banks and other large institutions (such as hedge funds, private investment vehicles and professional trading organizations). Newedge branches and subsidiaries generally offer qualifying clients direct market access ("DMA") trading through either internal order routing systems, independent service providers ("ISV") or sponsored direct market access ("SDMA") arrangements. Many of Newedge's clients are algorithmic or "black box" trading firms that engage in HFT. In addition to its DMA activities, Newedge branches and subsidiaries generally offer customers "live" execution and prime brokerage services. Newedge does not act as a dealer, market maker or specialist, and conducts no banking, advisory or fundamental securities research services.

Newedge has been actively involved with the industry for a number of years in promoting the establishment of fair, robust and transparent rules relating to HFT. Among other things, Newedge has provided comment letters on HFT and related topics to the EC, CESR, IOSCO, the US Securities and Exchange Commission ("SEC"), the Canadian Securities Administrators, the Ontario Securities Commission and the Financial Industry Regulatory Authority. In addition, Newedge has provided guidance to the US Commodity Futures Trading Commission ("CFTC") and the Futures Industry Association ("FIA") in connection with the development of best practices and guidelines relating to electronic trading in the US futures markets (including participating in a CFTC Technical Committee and Public Roundtable on this topic).[2]

2. HFT Generally

In our view, the ability of firms to process large amounts of market data quickly and transmit a large number of orders into the market in a short period of time has helped to increase trading volume which, in turn, has helped to increase liquidity, narrow spreads, reduce commissions and reduce overall transaction costs. Indeed, in terms of the speed and costs of execution, we believe today's markets are more efficient than ever before, and that HFT has played a significant role in this development.[3] In our view, marketplaces become liquid and maintain their liquidity (e.g., become efficient) by encouraging trading by multiple customer types – including HFT firms. IOSCO also appears to take the view that HFT has had certain positive market effects, including a general decrease in execution time and increase in liquidity.[4]

---

[2] Newedge is also a member of numerous industry associations involved in the development of HFT related rules, such as FIA, the Futures and Options Association ("FOA") and the Securities Industry Financial Markets Association ("SIFMA").

[3] We do note, however, that the increase in liquidity and decrease in spreads has occurred primarily among large-cap stocks; mid-cap and low-cap stocks appear to have felt less of the benefits of HFT.

[4] See e.g., Report, Section 4 ("a number of indicators point to an improvement in market quality [as a result of HFT]. Trade volumes have significantly increased … even in the context of one of the most turbulent decades in the

We also believe that HFT, in certain instances, has decreased volatility and thereby had a stabilizing effect on the market. Indeed, with respect to certain stocks, it appears that HFT firms have, on occasion, taken on the role of specialist or market-maker in "bridging the fluctuations between supply and demand that occur throughout the trading day."[5] As noted by Mr. Cameron Smith, General Counsel of Quantlab Financial, LLC, a Houston, Texas-based quantitative technology and trading company:

> [i]f only long-term investors were trading securities, there would not be adequate liquidity to keep markets stable and spreads narrow. Therefore, market intermediaries, whether traditional market makers and specialists or today's high frequency traders, are essential.

HFT firms have also helped to stabilize markets as a result of the market neutral and risk averse nature of their trading strategies. Indeed, HFT firms generally do not speculate or even take overnight positions, which we believe has taken some of the volatility out of the marketplace. In addition, we believe these same positive developments have helped "long-term investors," including retail clients, as well.[6] Among other things, as a result of increased liquidity and lower transaction costs, long-term investors, once they have determined to acquire or dispose of an asset, are often able to do so on a faster and less expensive basis. In addition, as a result of the stabilizing effects of HFT, long-term investors are less susceptible to market volatility, and therefore, less likely to lose the value of their investment in a short period of time. Rather than "demonize" HFT firms for current market issues, we believe these firms – which have succeeded based on their ingenuity and work ethic and which put their own capital at risk on a daily basis – should be recognized for helping bring about the market improvements identified above. The number of enforcement actions relating to HFT firms over the past few years are far and few between, while the market improvements they have helped to create are many.

That being said, we also believe, as we set forth below in more detail, that certain steps should be taken to "level the playing field" and reduce systemic risk with respect to HFT, including implementing "generic" or "industry-wide" pre-trade DMA filters and blocks and ensuring that co-location services are offered on a fair, transparent and cost-effective basis. We also believe, as noted, that abusive and manipulative trading strategies employed by HFT firms – or any other type of market participant for that matter – should be prohibited (to the extent they are not already) and that the perpetrators of such conduct should prosecuted vigorously.

---

history of financial markets. Execution speed has fallen from seconds to as little as microseconds ..... [s]ome measures of liquidity have improved with implicit trading costs").

[5] See Commentary: How High Frequency Trading Benefits All Investors, Traders Magazine Online News, March 17, 2010, Cameron Smith.

[6] The term "long-term investor" generally refers to market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time.

RESPONSES TO SPECIFIC QUESTIONS

Newedge sets forth below its responses to IOSCO Questions 2, 3, 6, 7, 12 and 13.

QUESTION 2: What are your views on the suggestion that proprietary trading firms (including HFT firms) that are not currently subject to registration/authorization by a regulator should be required to obtain such a registration/authorization? 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 do not believe that proprietary trading firms, including HFT firms, which access markets through registered brokers should have separate registration and authorization requirements. We believe markets (and the customers themselves) are adequately protected by the inter-positioning of a registered broker and a regulated trading venue which, together, are responsible for handling the customer's orders and trade executions. Consequently, we do not believe, for example, that the SEC's recently issued large trader rules – which will require customers exceeding certain trading volumes to register directly with the SEC – are necessary or will result in significantly greater or more useful information for regulators. Indeed, US brokers already are required to keep detailed information regarding their HFT and other DMA customers, and provide such information to regulators promptly upon request through, among other things, the SEC's electronic blue-sheet ("EBS") system. However, to the extent any customer is permitted to access a market directly without the inter-positioning of a registered intermediary – which we do not believe to be a good idea generally – such customer would, in our view, have to be registered with the appropriate regulator(s) and market center(s).

We also believe, contrary to the views of some, that HFT firms that execute a significant number of trades in a specific financial product should not be required to continue providing liquidity in that product on an ongoing basis subject to similar conditions that apply to market makers or specialist – at least unless and until such firms are given the substantial capital, margin and other relief generally provided to firms that make markets. In our view, imposing market maker type responsibilities on HFT firms without providing them the corresponding relief will have the unintended consequence of causing them to withdraw from the market.[7]

With respect to specific obligations, we believe HFT and other DMA customers should be: (a) required to provide documentary and testimonial evidence upon request by a relevant regulator; (b) subject to applicable anti-fraud, anti-disruptive and anti-manipulation trading rules and requirements, and; (c) required to establish internal written procedures necessary to monitor and control the orders they transmit into the market, and that such procedures should (i) be made

[7] We also believe that HFT firms should not be required to notify market centers or regulators of the computer algorithms they employ, including an explanation of the design, purpose and functioning of such trading strategies. We believe this is proprietary information which should be respected in the ordinary course. Further, given that HFT firms change their strategies frequently, such a rule would impose significant time and resource requirements on both firms and regulators.

available to their broker(s), market center(s) and regulator(s) upon request; (ii) require periodic supervisory reviews of high-risk business activities by competent managers, (iii) limit use of DMA trading systems to experienced personnel who must access such systems through password protected means, and (iv) require the implementation of pre-set risk and credit parameters on a per trader basis.

QUESTION 3: 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?

1. Naked SDMA Should Be Banned.

We recommend that "naked" SDMA arrangements not be permitted, and that regulators require the application of industry-wide or "generic" controls to all DMA trading (including both proprietary and customer trading). As a general matter, we believe that SDMA – i.e., a form of DMA in which a customer is able to access markets using its own or a market center's routing infrastructure – has, along with HFT and co-location, helped lead to positive developments in today's markets. Indeed, sponsored access traders, in general, are able to receive market data from and route orders to market centers more quickly than customers relying on brokers' or ISVs' routing architecture.[8] And, as we have noted, the ability to process market data quickly and transmit a large number of orders into the market within a short period of time has helped to increase trading volume which, in turn, has helped to increase liquidity and transparency, narrow spreads, reduce commissions and reduce overall transaction costs.

However, we also believe strongly that "naked" SDMA – i.e., where a customer is able to transmit orders into a market without its sponsoring broker or the market itself being able (or required) to regulate the compliance and risk aspects of such order flow – should not be permitted. We believe the systemic risk to the markets and the capital risks to individual customers and brokers that are inherent in naked SDMA arrangements are clear and, for the most part, undisputed. We also believe naked SDMA leads to increase regulatory and compliance related violations. Indeed, the SEC recently issued a rule, SEC Rule 15c3-5, which prohibits all naked SDMA in the US equity, equity option and fixed income markets. And, while we suspect that virtually all HFT firms, in order to preserve their capital, do utilize strong and effective filters and controls with respect to their DMA trading activities, we also believe that such filters should be under the exclusive control of their market intermediaries (as is required by SEC Rule 15c3-5). In this regard, we noted that IOSCO, in its Report, discusses SDMA arrangements but does not recommend specifically that they be prohibited. Given the significant compliance and credit risks associated with such trading, we urge it to do so.

[8] SDMA customers' routing systems and transmittal lines typically are faster than those used by ISVs and brokers since, among other things, such systems link to market centers directly and do not have to be shared among multiple customers.

2. Brokers and Market Centers Should Implement Generic and Harmonized Pre-Trade Filters.

In order to properly control DMA trading activities, we recommend that:

a. broad-based filters, blocks and controls - such as those relating to orders entered in error, away-from-the-market orders, trading halts, circuit breakers and stop orders – should be implemented by exchanges and market centers at the exchange level, and;

b. client-specific filters, blocks and controls – such as those relating to credit, share size and capital thresholds – should be created by exchanges and then provided to and customized by individual brokers to fit the financial and trading requirements of their customers.[9]

In our view, this two-tiered approach and shared allocation of responsibilities between brokers and market centers will yield important and pragmatic benefits. First, establishing exchange level controls, where possible, and providing brokers with exchange-created risk and compliance filters will, in our view, help to "level the playing field" among market participants with respect to latency. Specifically, we believe that if individual brokers develop and/or purchase their own controls, HFT customers will gravitate to the brokers offering the lowest latency but not necessarily the most rigorous controls. In addition to disadvantaging brokers and customers more concerned with ensuring compliance and reducing the risks associated with DMA trading, such an arrangement could, in our view, expose the markets to more systemic risk. In this regard, we also believe that regulators, with respect to both broad-based and client-specific filters, should mandate certain specific minimum controls that all brokers and market centers must implement, as opposed to merely requiring that they implement filters and controls "reasonably designed" to minimize credit risk and fulfill compliance requirements. For example, with respect to broker controls, all brokers should be required to impose filters or blocks relating to: per order share size limitations; per order dollar amount limitations; aggregate customer dollar amount limitations; order type restrictions; product restrictions; order handling restrictions; away from the market limitations, etc. The lack of at least some specific minimum controls and filters could result in a "race to the bottom" among less well-intentioned brokers and market centers.

Second, the approach we recommend would result in a more uniform system of DMA procedures and controls – at both the market center and broker levels – that, in our view, will allow customers, brokers and market centers alike to better understand and comply with the relevant rules, and allow regulators to enforce them more consistently and effectively. Indeed, one of the major requests we have heard throughout the discussion on DMA regulation is the need for uniformity and consistency among market centers and market participants.[10] We

[9] In creating such functionality, we recommend that market centers consult some of the leading HFT firms which, as previously noted, have over the years developed some very robust and sophisticated filters and blocks.

[10] As noted by SIFMA in its February 26, 2009 letter to the SEC regarding a prior DMA rule proposal:

believe markets globally have a need for and would benefit from a consistent and harmonized approach to DMA.[11]

Third, we believe our approach would help to address the potential inequity between HFT brokers and non-brokers. Specifically, an exchange member that trades in a proprietary (but not necessarily market making or specialist) capacity using its own filters will almost always have a critical but, in our view, unjustified latency advantage over a customer that has to route its orders through third-party filters (because of the extra server involved). Indeed, as a result of this potential inequity in the US, we understand that many customers engaged in HFT are strongly considering creating broker-dealers ("BD") solely for the purpose of staying competitive from a latency perspective. Unfortunately, many such BDs will, we believe, be thinly capitalized and poorly managed, at least initially, considering the haste with which they are likely to be formed. However, "leveling the playing field" by establishing uniform filters at the exchange and BD levels should help resolve this inequity and prevent the proliferation of underfunded BDs.[12]

In short, we believe the two-tiered and "shared allocation of responsibilities" approach to DMA filters and blocks that we are advocating here – which has worked for many years in the US futures industry – will work effectively globally to "level the playing field" and reduce systemic market risk.[13]

QUESTION 6: Who should bear the costs of investing in surveillance capabilities with respect to markets and modern trading techniques? Who should bear the cost of operating and supervising the markets in order to ensure fairness among market participants?

We believe the costs and responsibilities (and regulator exposure) associated with creating and implementing the controls necessary to properly control HFT and other algorithmic trading should be split evenly among all of the registrants that benefit from such trading, including the exchanges and market centers. The expense involved for brokers in implementing such controls – to the extent they are solely responsible for creating and implementing them – will be significant and, in some cases, prohibitive.[14] However, requiring market centers to (a) implement certain controls at the exchange level, and (b) provide brokers with "already

---

> SIFMA strongly believes that having a good, consistent, predictable and practical rule [regarding DMA] is critically important to the industry ..... [and that the current collection of exchange DMA rules and requirements] .....unfortunately deviate from one exchange to the next, creating inconsistencies, confusion and a host of disparate requirements.

[11] With respect to regulatory consistency, we recommend that sponsored access filters and controls be mandated not only at exchanges, but at non-exchange market centers as well (considering that much of today's order flow is executed through such venues). Indeed, we believe that to not do so would put exchanges at an unnecessary competitive disadvantage and increase order flow to less transparent markets.

[12] The creation of a large number of new brokers would also likely put a strain on regulators already dealing with reduced staffing and resources.

[13] Indeed, we are aware of no major incidents involving DMA trading in the US futures markets over the past ten years, despite the substantial increase in trading volume such markets have experienced during this time-period.

[14] Indeed, we believe the expense of implementing such controls may result in certain smaller brokers leaving the market or consolidating with larger brokers. It is imperative that IOSCO consider anti-competitive effects on market participants in crafting and issuing its principles and recommendations.

assembled" controls to be implemented at the broker level would alleviate much of the financial and regulatory burden that would otherwise be placed on brokers.

In its Report, IOSCO states generally that both market centers and brokers should implement controls reasonably designed to manage the risks of DMA and SDMA. See Report, Chapter 2, Section 3. However, for the reasons set forth above, we urge IOSCO to recommend more specifically that (a) market centers be responsible for implementing broader and more generic type filters and controls, such as those relating to trading halts and circuit breakers, and (b) intermediaries be responsible for implementing more customer-specific controls, such as those relating to credit and risk parameters (using market center developed filters).

QUESTION 7: 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 one of the primary reasons for the recent spate of settlement failures involving HFT and other algorithmic trading is certain market centers' lack of definitive clearly erroneous trade cancellation rules. Setting forth clear and reasonable clearly erroneous trade rules will put participants on notice of their risks and responsibilities in the event of a market dislocation. In addition, the greater legal certainty such rules will provide market participants will help to decrease the likelihood that they will withdraw their orders during highly volatile markets.

In general, we believe that a market center's clearly erroneous trade cancellation rules should:

- mandate that (a) trades executed within enumerated price ranges (i.e., trades that are not clearly erroneous from a pricing perspective) will not be cancelled, and (b) trades executed outside of such price ranges will be cancelled absent a compelling public interest to the contrary;

- allow counterparties to undertake, as necessary and appropriate, different types of remedial actions in response to the execution of clearly erroneous transactions, but emphasizing that, in most cases, price adjustment is the preferred remedy;

- clarify the types of transactions resulting from clearly erroneous trades that may also be subject to cancellation, and;

- require that information relating to the review and cancellation of clearly erroneous transactions be disseminated by market centers quickly and fairly to market participants.

The addition of these provisions will further the two primary objectives of any erroneous transaction policy; namely, to: (a) protect the integrity of the market by providing a mechanism for canceling those trades that are so clearly erroneous that they may adversely, and unacceptably, affect other market participants, and; (b) install confidence that, once executed, transactions will stand and will not be subject to cancellation arbitrarily. As stated by SEC Chairman Mary Schapiro in connection with the SEC's review of various market center clearly

erroneous trade policies after the May 6, 2010 "flash crash," transparent and reasonable clearly erroneous trade policies – applied evenly across different market centers – will build investor confidence by "provid[ing] certainty in advance as to which trades will be broken, and allow[ing] market participants to better manage their risks."[15] We discuss below in more detail the first and second bullet points listed above.

1. "No-Bust" Zones

In order to strengthen investor confidence in the integrity of markets, market centers should mandate that trades executed at prices that fall inside of pre-set numerical guidelines will not be broken absent a compelling public interest reason to the contrary; i.e., they should create firm "no-bust" zones (which are common in the US futures markets). As stated by the FIA in its Exchange Error Trade Procedures Recommendations for Best Practices (September 2004) ("FIA Best Practices") at 3:

> one component of market integrity is the assurance that, except in extraordinary circumstances, once executed, a trade will stand and will not be subject to cancellation. In this regard, therefore, it is essential that trades that do not have an adverse effect on the broader marketplace should not be able to be cancelled, even if executed in error.

Indeed, FIA recommends that all US futures exchanges adopt a "Preferred Adjust-Only Policy" in which all trades executed at prices inside of a product-specific "no-adjust" range are ineligible for adjustment.[16] We believe such a requirement would increase investor confidence in the integrity of markets globally as well. In short, while we do agree that a certain amount of discretion must be afforded to market centers to allow them to address unique circumstances, absent a compelling public interest to the contrary, trades executed inside of established price ranges should not be cancelled and trades executed outside of such price ranges should be cancelled.

This view appears to be supported generally by IOSCO. See Final Report Policies on Error Trades (October 2005) ("IOSCO Error Report") at 10:

> The IOSCO *Principles* [regarding the handling of clearly erroneous trades] contemplate that exchange rules will be applied consistently and fairly and that no market user should be favored over others. A comprehensive policy that eliminates ambiguities and contemplates in advance the necessary processes and probable consequences of invoking and canceling a trade helps to achieve these goals by allowing market users to understand in advance the circumstances under which a trade may be cancelled, the type of trades that may be cancelled, the parties who may challenge the trade and the scope of all exchange actions once the policy is invoked.

---

[15] See also SIFMA Policy Statement and Guidelines Regarding Error Trade Policies for Interdealer Brokers (March 2007) ("SIFMA Policy Statement") at 3 ("[e]rror trade policies need to strike the proper balance between resolving trades that were clearly transacted in error and the expectation of market participants that once executed, trades will stand and will not be subject to arbitrary cancellation").

[16] See FIA Market Access Risk Management Recommendations (April 2010) ("FIA Recommendations") at 14.

Stated another way:

> [i]f the policies concerning trade cancellation are not known with certainty, then traders may act in a manner that adds to volatility during periods when 'erroneous trading' is affecting market prices.

IOSCO Error Report at 8.[17] However, we recommend that ISOCO specifically endorse the use of "no-bust" zones by regulators and market centers.

2. Remedial Actions, Contingency Trades and the Dissemination of Information Relating to Clearly Erroneous Transactions.

Market center rules should also identify the different remedial actions that counterparties may take in resolving clearly erroneous trades. We believe different remedial options should be made available to investors given that different types of transactions can require different resolutions.[18] That being said, we also believe the preferred method for resolving clearly erroneous transactions, in general, should be price adjustment, as a policy of breaking trades can cause traders to withdraw liquidity during times of market stress which can further compound a market dislocation. Finally, rules relating to the resolution of erroneous transactions should be consistent among market centers and stated clearly in their procedures.[19]

Market center rules should also address the types of contingent transactions that may be cancelled if an erroneous trade is cancelled – i.e., trades triggered by a clearly erroneous transaction (such as stop orders) that are themselves executed at clearly erroneous prices. Indeed, Chairman Schapiro, in her testimony regarding the flash crash on May 6, noted that some of the clearly erroneous transactions that took place triggered customer stop loss orders that themselves were then executed at clearly erroneous prices. Schapiro Testimony at 8. While Newedge does not at this time offer a view as to when contingent trades should be subject to

---

[17] See also Testimony of Mary L. Schapiro Concerning the Severe Market Disruption on May 6, 2010 (May 11, 2010) ("Schapiro Testimony") at 16 (the SEC must "work with the various exchanges and other trading venues to assure that the process and policies for dealing with the correction of erroneous trades are fair for investors and consistently applied"); SIFMA Policy Statement at 4 ("[p]olicies and procedures that eliminate uncertainty and ambiguity, and that will be applied consistently and fairly so that no market participant will be favored over any other, will enhance a sense of fairness. Such policies and procedures will also provide the ability for market participants to understand and evaluate risks and to price and manage that risk"); FIA Recommendations at 14 ("subjectivity or ambiguity in an error trade policy amplifies risk through uncertainty").

[18] In our view, some of the different resolutions market center rules should provide for include: adjusting positions; adjusting prices; cancelling trades; reversing trades, and; allowing pre-arranged off-setting transactions. See SIFMA Policy Statement at 8 (the "types of remedies that may be prescribed should be articulated in an error trade policy" and may include options in which: a trade can be "broken or modified;" the "price or size of the trade may be adjusted;" the "trade may be reversed;" positions "may be transferred between market participants;" "[c]ash/price adjustments may be made" and "prearranged offsetting transactions" may be executed).

[19] See, e.g., SIFMA Policy Statement at 5 ("any lack of transparency and certainty concerning ..... how cancelled trades are treated is a source of operational risk ...").

cancellation, we do believe that market center rules should address the issue and that such rules should be consistent.[20]

Finally, market center rules should state how news or information regarding the review and cancellation of clearly erroneous trades will be disseminated to the market. Without question, such information can be of significant interest to market participants, and thus, the prompt and fair disclosure of such information is critical to the efficient and transparent operation of today's markets.[21] Consequently, in our view, market center rules should, in a harmonized and consistent fashion, mandate that such information be disseminated quickly and in a non-discriminatory fashion to market participants in order to minimize market impact and not favor any one group of market participants over another.[22]

QUESTION 12: Should market operators be required to make their co-location services available on a fair and non-discriminatory basis?

We believe that co-location services should be regulated, so as to ensure that they are (a) adequate, and (b) made available to all market participants on a fair and transparent basis. Co-location, in the context of today's markets, generally involves a HFT firm locating its trading server(s) in close proximity to a market center's matching engine.[23] The advantage of co-location to HFT firms is speed, in that it reduces the communication time between the trading firm's server and the market center's matching engine.[24] For the reasons set forth below, we believe co-location should be permitted, but regulated.

From a purely performance perspective, a well-maintained co-location center can offer many significant advantages over housing one's trading server in a normal office location. For example, co-location centers often have (a) more reliable uptime, (b) better network speed and reliability, (c) better power redundancy, (d) more redundant and improved cooling and environmental air conditioning, (e) lower set-up and monthly costs, (f) more available network and server specialists, and (g) higher internet bandwidth availability than do normal business office locations. In addition, co-location space is still relatively inexpensive and readily available. We believe the significant storage and maintenance safeguards available at high quality co-location centers not only assist trading firms with the speed and accuracy of their executions, but reduce overall systemic risk to the market. Consequently, we believe that, as a

---

[20] FIA recommends that contingent orders executed as a result of an error trade be eligible for compensation from the party that made the error. See FIA Recommendations at 14.

[21] See IOSCO Report at 13 ("[b]ecause error trades can have an immediate effect on price formation (*e.g.*, through reliance by traders on such information or the triggering of contingency trades), knowledge that a trade has been *challenged* by a party and *taken under review* by an exchange and/or subsequently deemed to be a valid error trade and in fact *cancelled* could be, depending upon the circumstances, highly material to the accuracy of the price formation process and to the trading decisions of market users").

[22] See FIA Best Practices at 2 (to "assure that market participants are aware that an erroneous trade may be cancelled, exchanges should implement procedures to provide prompt notice to the marketplace of both a request to cancel a trade and the exchange's decision with respect to such request").

[23] Co-location is commonly practiced today. Indeed, the NYSE recently built a 400,000 square foot facility in Mahwah, New Jersey and another one outside of London, at a combined cost of Euro 365 million to facilitate its members' co-location needs.

[24] It is estimated that co-location creates a 100-200 millisecond advantage over a regular vendor based provider.

general matter, co-location facilities further IOSCO's (and other regulatory authorities') goals of increased market liquidity, lower transactional costs and narrower spreads.

However, in order to ensure that co-location facilities are of high quality – and remain relatively inexpensive, transparent and available – we believe such facilities must be regulated closely. Indeed, given the fact that trading in today's markets is primarily electronic, and that trading servers and matching engines are the "lifeblood" of electronic trading, we do not believe it would be over-reaching (in a jurisdictional sense) to regulate such venues. We also believe that to the extent regulators were to disallow market centers from offering co-location services, non-regulated entities in close physical proximity to them would provide such services in an unregulated context, which could lead to low grade facilities and the unfair and unequal allocation of co-location space.

In determining regulatory requirements for co-location facilities, regulators should consider the following:

a. Each facility must meet certain physical, systems, disaster recovery, maintenance and environmental requirements and safeguards.

b. Each facility must be inspected by regulators at least once annually.

c. Services offered by co-location facilities must be transparent and available on consistent terms to all participants.

d. Space within a co-location center must be allocated fairly so as not to give certain members a timing advantage.

e. Non-regulated entities providing co-location services must consent to and abide by such rules and regulations.

Importantly, we do not anticipate that market centers or even currently unregulated entities offering co-location facilities will object to such regulation. Indeed, the Nasdaq Exchange in the US recently consented to the SEC's regulation of its co-location facilities, including having to obtain SEC approval for certain pricing changes.

In its Report, IOSCO states that co-location "raises issues related to potential distortion of competition between market members, equal access to the market and the cost of such services" (see Report, Chapter 2, Section 3(d)), but does not recommend specifically that co-location (a) be regulated, or (b) made available to all market participants on a fair and transparent basis. For the reasons stated above, we recommend that it do so.

QUESTION 13: Should market operators be required to provide testing environments to enable participants to stress test their algorithms?

Yes, we believe all market centers should be required to maintain test environments that will allow their DMA customers, brokers and related ISVs and other third-party vendors to test not

only new trading strategies and algorithms in a non-"live" environment, but also test, among other things, new: connectivity, default or back-up server arrangements, transmission lines, mnemonics, give-up arrangements, MPIDs, order and trade capture systems, exception and surveillance reports, order routing systems and software, risk and compliance controls and filters and third-party vendor DMA functionality, systems and mechanisms. As a global broker that provides DMA and SDMA to customers employing multiple trading algorithms through a variety of different internal and external order routing systems across numerous asset classes, we have witnessed first hand the need for market centers to have robust testing environments. Unfortunately, some market centers we have encountered do not, which has, on occasion, caused customers to either forego testing they should have conducted or test their new systems, software and connectivity in a live environment or conduct only minimal, and in some cases less than adequate testing in a live environment in order to minimize their capital exposure. In our view, any market center that accepts orders on a DMA or SDMA basis should be required to have a robust test environment for brokers and their customers and third-party vendors, and should in fact require that certain types of new systems and software be tested prior to use in a live environment.

* * *

We greatly appreciate IOSCO's efforts in soliciting the public's views on these important issues, and for all of its actions in making global financial markets more efficient, transparent, liquid, cost-effective and fair.

Thank you again for allowing us an opportunity to comment on the Report. If you have any questions regarding the matters discussed herein, please do not hesitate to contact the undersigned at +1 646 557-8458 or John Nicholas, Global Head of New Regulation Monitoring and Implementation, at +1 646 557-8516.

Sincerely,

Newedge Group SA

By

Gary DeWaal
Senior Managing Director and Group General Counsel
Newedge Group