OICV-IOSCO CONSULTATION REPORT

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

Comments by AMAFI

Association française des marchés financiers (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of the members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to comment on the Consultation Report (hereafter referred as to the "Report") on *"Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency"* issued by the Technical Committee of the International Organization of Securities Commissions. Nevertheless, AMAFI regrets the short delay given for the consultation on such important issues given that the call on IOSCO to develop and report to the FSB was given in November 2010. Although the Report gives a very detailed and useful description of technological evolutions since these last few years, as well as of certain developments in market structure, it does not provide any new fact or element that would allow finding appropriate solutions. The terms of the debate have been clear and well-known for months. Without no new data nor academic studies, it is almost impossible to bring a truly useful and new input, especially in the very short consultation period offered. For all these reasons, many of the comments that AMAFI presents below have already been expressed on various occasions in the past.

Before answering the questions raised in the Report, AMAFI would like to emphasise some general comments.

I) GENERAL COMMENTS

We have chosen to focus our comments on the questions raised by the Report on High Frequency Trading (HFT) and not to comment all the items of the Report. Moreover our comments essentially concern the equity market where issues raised by HFT are the most relevant. We do not have specific comments on the other subjects.

AMAFI welcomes IOSCOs' initiative to assess the regulatory issues raised by the developing of HFT. In particular, we fully share the very well balanced and detailed part of the Report contained in chapter 3. This part of the report, while underlining the merits of HFT for increasing liquidity or reducing bid and ask spreads[1], also points out the various issues raised by this type of trading, not only with regards to the very large amounts of transactions that it leads to, but also with regards to the changes in the market structure which seem to result from it. The whole point of the current work going on about HFT is to determine whether there is a link between some of these negative evolutions and the development of HFT or with

[1] AMAFI shares also the view that there is no clearly established link between HFT and volatility, be it with positive or negative consequences.

other factors. Then, should HFT be found responsible for these evolutions, it would be necessary to compare the advantages it brings with its negative consequences in order to decide for a more or less stringent regulatory framework.

In this regard, while many regulators have, as pointed out by IOSCO, engaged in an in-depth analysis of HFT for several months, there is still unfortunately no evident answer to these issues due to the lack on commonly admitted academic study based on accurate data.

In addition, the AMAFI shares the analysis put forward in the Report about the question of possible market abuse practices due to the developing of HFT. Obviously, there is a concern whether HFT techniques offer the possibility of engaging in abusive practices on the various markets. But we have to consider that, paradoxically, it is easier for regulators to detect and prove mispractice in the technical environment that characterize HFT than to detect and prove them when they are carried out by a human being.

Having said that, it is clear that there is a need to better control and monitor the activity of automated trading and high frequency trading. It is necessary to reinforce the prevention of the specific risks involved by HFT by imposing sound systems of risk management and supervising all entities involved in HFT. The regulatory bodies should have the capacity to register / authorize all HFT firms and enforce and even ban those which are developing market abuse practices.

While the merits and the drawbacks of the increase in HFT have not yet been fully analyzed and put forward, AMAFI observes that three types of technical measures are frequently considered in order to monitor and regulate HFT activities.

- Requiring orders to rest on the order book for a minimum period of time.

  AMAFI really doubts that putting in place such tools would be efficient. This would lead some market participants to try to take advantage of these constraints with unforeseeable consequences on the micro structure of the market. AMAFI is pleased to see that the Report does not envisage such type of regulation.

- Imposing market operators a minimum period of time between two quotes.

  There is no consensus among AMAFI's members on this question. When some of them support such a measure, others consider that it would have a negative impact on liquidity. This proposal could be studied by the regulators in relationship with market participants.

- Giving the regulators the power to adapt the tick size as a way to "slow down" the development of HFT if it appears necessary.

  This proposal is shared by a large majority of AMAFI's members which consider that it could be an efficient way to monitor HFT when it appears necessary.

II) IOSCO questions

- ***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?***

What is at stake is not technological developments in general: these cannot be considered, as a rule, as negative since they allow market participants to improve the services they offer to issuers and investors while decreasing the cost of these services. The issue at stake is HFT which, within the last decade, is estimated to have grown from negligible amounts to an estimated 60-70% in equity trading volume in the US and to 30-50% within the EU. This significant increase raises concerns expressed by different market participants (brokers but also issuers and investors) and by some regulators as stated in the Report. In this regard, some of AMAFI members have identified the following characteristics of the market environment as a result of the increase in HFT:

- Execution of large orders made more difficult because of the reduction in size of transactions ;
- Investors more and more frequently asking for alternative tools for order execution so that their orders cannot interact with those of HFT firms; this in turn leads to the development of dark pools and broker crossing networks;
- Increased costs of transaction for some market participants because of the technological investments that trading platforms must engage in order to attract transaction volumes generated by HFT (*see also Q11*).

These negative consequences are not, however, shared by all AMAFI members. For some other members, the benefits from HFT in terms of liquidity improvements, narrowing of spreads as well as with regards to volatility, are much higher than the negative impact of HFT.

The orderly functioning of the market is, in the end, at stake. It is therefore crucial that this debate be closed on the basis of a precise and exhaustive analysis of all these elements.

- ***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?***

AMAFI fully supports this proposition. It is crucial: all entities involved in HFT should be regulated and supervised. At this stage, there is no evidence that this activity put in danger the safety and the integrity of the markets. But there is a clear need to monitor them. At least, to be able to follow precisely the activity of HFT firms and answer the numerous questions which are currently raised. But also, to give regulators the power to forbid the activity to firms which do not respect the rules of the game, especially on the market abuse side. Given that, the registration / authorization should, of course, also be applicable to entities which access the market as the customer of an intermediary firm through DEA.

The minimal suite of requirements should include: fitness and propriety (honest, competent and solvent); internal systems and controls; financial adequacy; ability to fail without affecting the system; record keeping. The regime could be a subset of existing requirements (e.g. not able to hold client money; not able to act as adviser, investment manager).

AMAFI also considers that there is no need to have an *ex ante* approval of HFT models by the regulators but HFT firms should be required to keep records of their models, at the disposal of the regulatory bodies.

- ***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?***

AMAFI considers that high-level requirements for adequate systems and controls should be put in place by firms using HFT and algorithmic trading. But in this area the most important thing is to give regulators the means to supervise these firms which means the ability to register / authorize them, to enforce their activities and, when necessary, to sanction them, even in withdrawing their registration / authorization to carry out HFT.

- With regard to pre-trade risk controls:

  Reviewing existing regulatory requirements regarding pre-trade risk controls applicable to intermediaries could be useful.

  We think that regulators should consider banning DEA in case of naked access (i.e. when no appropriate pre-trade controls are in place). We believe that naked access may have significant negative consequences because customers are able to access to trading platforms both without pre-trade risk control and without revealing their identity to the market.

  This is the reason why we fully support measures recently taken by the SEC.

- With regard to post-trade risk controls:

  We think that post-trade risk controls could be usefully increased by the implementation of a consolidated tape.

  In the EU, difficulties have arisen concerning post trade data consolidation. It seems to be the major failure of MiFID. Data are neither harmonised, nor available nor reliable. Such a consolidated tape would allow the regulators to perform their supervisory functions.

- ***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)?*

AMAFI believes that at least platform-based circuit breakers should be mandated. There are sound arguments suggesting that in fully electronic markets – even more if a growing part of orders executed are purely computer driven – at least platform-based effective "circuit breakers" (e.g. "volatility-interruptions") should be in place to provide for an orderly function of the market in periods of stress and in order to minimize the risks arising from erroneous trades or program failures.

This implies an efficient coordination among the regulators at least in the main regional areas (US, Europe, Asia…).

- ***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?*

Generally speaking, existing commitments for e.g. of market makers / specialists on trading venues are subject to contractual arrangements between the market operator and the market making/specialist firm. Such arrangements did prove valuable and sufficient even under the most severe market conditions and there is no need for additional regulatory intervention.

In the specific case of HFT, we think that if some HFT firms are willing to enter into a market maker agreement with a trading venue, they should be encouraged to do so under strict conditions agreed together with the relevant trading venues. We believe that current contractual arrangements between those venues and the market makers already provide a safety environment and encourage competition between trading venues (notably with regard to the fee structures).

Furthermore, it has been reminded that in the EU trading venues are either market operators or investment firms providing the investment service of management of an MTF. As such, they are submitted to a strict regulatory framework. In that context, regulators are entitled to investigate and analyze how contracts with market makers have been designed.

Finally, regarding "stub" quotes (i.e. quotes at levels far away from current market prices used sometimes to fulfill a market making requirement), we share the suggestion that they should be banned as they could be assimilated to some form of market abuse.

- ***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.

For AMAFI, the first level of market surveillance should be imposed to all market operators. They should be required to have adequate surveillance capabilities in place which are able to efficiently monitor (and if necessary to intervene in due time) trading.

Then, the regulators should have the capacity to supervise the markets in their own jurisdiction but also on a cross boarder basis when a single security is traded in various jurisdictions. This does not necessary means that that regulatory bodies have to develop the "high frequency" systems of supervision in order to follow the trends and it is not obvious that there is a need for real time supervision. An ex post sound supervision of the markets would be probably as efficient without imposing on regulators to develop the complex technical tools which would be necessary to do so. In such respect, it is important that HFT firms keep their algorithms during a sufficient period to permit to regulators to control them ex post.

Modern trading techniques have made necessary for regulators to adapt their surveillance capabilities. We think that the following improvements may be considered:

- to build, as mentioned below, a registration / authorization process for proprietary trading firms (including HFT firms) and to consider the ban of DEA in case of naked access;
- to build and use a consolidated tape: in a context where data are neither harmonized, nor available nor reliable, such a consolidated tape would allow the regulators to perform their supervisory functions, notably detecting potential market abuse on an ex post basis;
- to improve the way regulatory reporting are made: conditions of such reporting (in terms of timing, format etc.) should be harmonized at international level (for instance amongst Member States in the EU).

With regards to costs, we consider that there is no issue specifically related to HFT. They conduct an activity which is a form of proprietary trading and should not be treated differently from other entities conducting this type of activity. As long as a given activity does not compromise the orderly functioning of the market, there is no reason to apply to it a specific principle. However, if an activity has an adverse impact on the orderly functioning of the market, then it should be forbidden.

- ***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?***

We are not aware of any settlement indiscipline or failure which would be directly linked to HFT. We underline the fact that most of our members' strategies imply a net flat position at the end of each trading day which prevents settlement indiscipline or failures to happen.

Nevertheless, when volatility and volumes are particularly high, any additional liquidity may be difficult to manage by the relevant post-trade infrastructures. Clearing houses and central securities depositories should be robust and be submitted to appropriate requirements in order to be able to provide their services properly and avoid any failure or buy-in.

It has to be underlined that the European Markets Infrastructure Regulation (EMIR) envisages creating such a framework including for post-trade infrastructures providing their services in the cash equity environment.

- ***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.***

AMAFI considers that, at least in Europe, the current provisions on conflicts of interests already exists and are sufficient to deal with all the situation. HFT does not raise any particular issue in this area.

- ***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 are applicable and appropriate. However, there might be a monitoring and enforcement problem – often arising from insufficient resources on the regulatory side. But if all HFT firms are subject to registration / authorization by a regulator and if they have to keep their algorithms for enforcement needs, the difficulties are not specific to HFT.

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

There is no reason to consider that strategies employed by HFT firms are different than those employed by other firms. The speed of the strategy is not a concern in itself if the regulatory bodies have the capacity to supervise the market (*see Q5 above*).

Having said that, as mentioned above, we think that when volatility and volumes are particularly high, any additional liquidity may be difficult to manage by the relevant post-trade infrastructures. Clearing houses and central securities depositories should be robust and be submitted to appropriate requirements in order to be able to provide their services properly and avoid any failure or buy-in.

- ***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?***

The question of messages cancellations or high orders to trade ratios is a very important one as some observers consider that it has a direct impact on market structure. As such a regulatory answer cannot consist only in regulating fees charged by trading platforms.

However, AMAFI is of the view that regulators should now focus their attention on the general fee structure of trading platforms as this fee structure may have a direct impact on market structure, the more so as competition is low, competition being to be considered not on a global basis but for each listed security.

Many AMAFI members, especially those who have a large activity on medium and small caps, for which the level of competition is low, or nil, consider they should not be asked to contribute to the cost of technological investments by trading platforms to attract firms who generate high volumes on blue chips. One should keep in mind that the main cost of a market operator provides from its IT system which is put in place in order to absorb the highest pick of exchanges of messages in the smallest period of time.

Therefore, it is necessary to work on the assumption that the fee structure should be neutral for all market participants.

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

Access to market infrastructure should be offered on a non-discriminatory basis in general; this also holds true for co-location facilities. Even more since co-location inevitably creates a form of "privileged access" to a trading venue itself, which can raise questions of overall fairness of a market place. It is hard to deny that those market participants who are not able or do not want to invest in co-location arrangements increasingly find themselves at a technological disadvantage. However, the economic impact of such a competitive weakness may still vary according to the individual business model. Therefore, if co-location facilities are accepted and available, regulation should ensure that the "barriers of entry" to use these services are as low as possible. Here, a non-discriminatory access is a necessary pre-condition.

- ***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?***

Participants are responsible for their own work; they should be able to buy 'canned' market data from the exchange to test their algorithms but the firm is responsible for stress testing according to its resources and risk appetite.

Nevertheless we believe that testing environments designed by market operators should be helpful to enable HFT firms to test their algorithms. That being said, such tests should not imply any disclosure of strategies or algorithms to those market operators. The latter should only be mandated to design and make available a relevant testing environment. Furthermore, we should highlight the fact that such testing environments should be used at the discretion of HFT firms that can choose not to use them notably for their strategies which do not fit with / require such testing environments.

- ***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?***

As stated above, the setting up of the tick sizes could be done by the regulators. The regulatory bodies (ESMA for Europe) could be given the necessary power to act in the matter in order to deeply analyze the situation with respect to the micro structure of the financial markets so as to determine appropriate levels of those tick sizes, closely monitor their evolution and promptly react where needed. In first analysis, if it were considered necessary, an increase in tick sizes could even be a way to control the development of HFT.

The tick size should be fixed equity by equity.

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