INSTITUTE FOR AGRICULTURE AND TRADE POLICY

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

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Dear Mr. Bijkerk:

The Institute for Agriculture and Trade Policy (IATP) is pleased to submit the following comment on the IOSCO consultation report. The focus of our concern is the effect of High Frequency Trading (HFT) on commodity markets. IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minneapolis with offices in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009. The CMOC is an alliance of commercial hedgers and public interest groups that advocates for government policies to ensure transparent and orderly markets that serve the interests of bona fide hedgers and consumers.[1] Both as a member of the CMOC and as an individual organization, IATP has submitted several comments on Commodity Futures Trading Commission (CFTC) rulemaking to implement Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). IATP has also responded to European Commission consultation papers on the Market Abuse Directive and the Market in Financial Instruments Directive revisions currently in process.

A representative selection of our work is included in the anthology, *Excessive Speculation in Agricultural Commodity Markets: Selected Writings 2008-2011*.[2] IATP began research and advocacy on commodity market regulation for two reasons: 1) many U.S. farmers were unable to forward contract a crucial part of their production, resulting in a farm cash-flow crisis, because rural banks would not lend to grain elevators and other first points of sale, due to extreme futures market price volatility driven by over-the-counter commodity index funds[3]; 2) agricultural commodity price spikes triggered a food security crisis in Low Income Food Dependent Countries (LIFDCs) that could not afford the margin collateral to risk manage the cost of crucial imports. Because most LIFDCs are price takers with little if any market power, the decline of futures prices in developed countries have not resulted in comparable price declines in those countries.[4]

General comment

First, IATP congratulates IOSCO on having produced a very informative consultation paper on a suite of complex trading practices, and amidst many other obligations, including advising the Group of 20 finance ministers. IATP understands that the "Report," and presumably the advice that IOSCO will give to the G-20 finance ministers in October, concerns derivatives markets, as well as a primary focus on cash equity markets.[5] While our comments focus on commodity derivatives, the Report notes that financial institutions practice HFT in several asset classes, including cash equities and

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commodity derivatives, by means of algorithms designed to price risk across various asset classes regardless of the substantive characteristics of each asset class. (p. 10) Algorithmic trading came to public attention when, driven by HFT enabled strategies, they hyper-rapidly inflate and then deflate liquidity in cash equity markets, notably the "flash crash" of May 6, 2010, as rightly summarized by the Report (p. 11). Better Markets, Inc. in a comment to the CFTC, noted "Many high frequency and algorithmic trading practices provide minimal value to the market,"[6] adding that the increased trading volume provided by HFT is often confused with liquidity needed for price discovery.

It is not clear to us how or what regulation can improve the quality of liquidity provided by HFT, as long as some actors in the financial system benefit from a fee-structure that rewards ever greater trading volume, regardless of the effect of that trading volume structure on market integrity and price formation transparency. IATP does not have a proposal for regulating the incentive structure that rewards sheer volume of trading over providing liquidity in ways that promote market integrity and efficiency. Nor does IOSCO raise the question of incentive structure in this consultation paper. However, the Report poses a question (Q 11) about the high order-to-trade ratios that result from "spoofing," i.e., placing orders without completing the trade to elicit information from competitors. Rather than attempting to reduce "spoofing" through application of a data processing fee, IOSCO may wish to consider whether proposing an incentive structure that would discount "spoofing" orders might better discipline a practice that disrupts price discovery and price formation. IATP does not believe that improvements to pre- and post-trade data transparency and other regulatory options outlined in the Report will suffice to repair the damage to markets by trading practices in which price discovery is impeded by assets that are held for seconds before being traded again. A proposal concerning the HFT incentive structure should be among the regulatory tools considered by the G-20 finance ministers.

IATP agrees with the "Report's" view that "Given that relatively few jurisdictions currently have regulations that are designed specifically to address algorithmic trading or HFT, market authorities should consider whether tailored regulatory requirements should be introduced, especially in those markets where algorithmic trading or HFT is a dominant component of the market structure." (p. 38) We believe that part of this tailoring should concern the specific needs and characteristics of commodity derivatives markets. In responding to a few of the 14 questions that IOSCO puts to "interested parties," we indicate some regulatory measures specific to commodity markets.

HFT and commodity derivatives

HFT-fueled algorithms can and have disrupted the orderly and transparent functioning of commodity derivatives markets. The HFT dumping of Exchangep-Traded Funds(ETFs) is the likely major cause of a much less publicized commodities "flash crash" just a year later.[7] In April, a Financial Stability Board (FSB) note characterized the movement of ETFs in commodity derivatives as a one of a number of "disquieting developments" as ETFs evolved from "plain vanilla" mutual fund like instruments to become composed of derivatives of an index of assets, with greater complexity and opacity than mutual funds.[8] Unlike the mutual funds that are valued once a day, the theoretically continuous valuation of ETFs is provided by HFT in transactions that can incorporate financial information, if no other kind of market information, in milliseconds. The FSB warned that "the expectation of on-demand liquidity [by ETF investors] may create the conditions for acute redemption pressures on certain types of ETFs in situations of market stress."[9] The FSB here presciently describes one of the structural features of the May 2011 commodities price collapse. Because price "circuit breakers" are designed to be applied for *force majeure* events, no circuit breaker could manage the price volatility and resulting demand to "cash out" created by a trading practice that exists for the sake of satisfying on-demand liquidity.

Unless and until ETFs and over-the-counter index trading are regulated to enable price discovery and price risk management for bona fide hedgers, HFT will exacerbate commodity price volatility both resulting from fundamental factors and from the dominance of ETF and OTC index fund weight of money. As a summary of interviews with commodity traders by the United Nations Conference on Trade and Development (UNCTAD) makes clear, "[v]olatility makes price discovery more difficult in all commodity markets. It also makes hedging more difficult and expensive, as large price movements may trigger margin calls [...] HFT is not helpful for hedging, because positions are not held over long periods of time. Further, the volatility caused by HFT discourages hedgers from using the exchanges."[10] Most physical commodity traders do not have the resources to finance margin calls over the structured volatility that HFT trading of index funds causes. Many physical commodity traders can no longer afford to hedge in futures and options markets and abandon commercial hedging as a risk-management tool. These trader views are confirmed by the change in the composition of traders in CFTC regulated commodity markets. Prior to deregulation under the U.S. Commodity Futures Modernization Act of 2000, speculative trading had accounted for about 15-30 percent of the total market, depending on the commodity, with commercial hedging as the dominant transaction. Post-deregulation, financial speculators drove commercial hedgers to occupy minority positions of open interest across all commodities for which the CFTC has reliable data.[11]

Whether HFT and algorithmic trading practices provide necessary liquidity to enable significant price discovery and price risk management is a key question that will not have the same answers for each and every asset class. Whereas HFT may be able to provide useful information for price discovery and price risk management in the vastly larger notional value of interest rate or exchange rate derivatives, in the relatively small notional value of commodity derivatives, IOSCO should evaluate whether fundamental factors such as deliverable supply of the underlying assets of commodity derivatives vary so rapidly as to require the huge trading volume that HFT provides. To the "stress test" that IOSCO panel participants have suggested for computer technology infrastructure (p. 39 and Annex 2) and to the consideration of a proposed ban on "flash orders" of less than one second, (p. 39), IATP would add that there is an urgent need for improvements to market surveillance that are not provided by the panel proposed order and price quote audit trails and trading entity identifiers, however useful these measures would be.

Rather than orient proposed improvements in market surveillance towards attempting to detect a more rapid and technologically sophisticated form of market manipulation (p. 40), IATP believes that market surveillance options that IOSCO presents to the G-20 finance ministers should be oriented to preventing the broader problem of excessive speculation in commodity markets that HFT strategies may enable. Thus far, IOSCO and indeed the G-20 finance ministers have refrained from making any recommendations concerning excessive speculation. IOSCO's Technical Committee on Commodity Futures Markets report in June 2010 to the G-20 finance ministers focuses its recommendations on providing the legal framework to enforce measures against market manipulation.[12] The November 2010 report of the Technical Committee to G-20 finance ministers emphasizes that Committee regulators have no legal authority to demand great transparency of physical commodity markets wherein much market manipulation occurs.[13] Although IOSCO has called for greater transparency in physical commodity markets, as Brazil has observed in a comment to the G-20, transnational commodity traders benefit greatly by keeping these markets opaque, hence physical commodity data transparency initiatives face an uphill climb.[14]

Rather than focus on initiatives where IOSCO's member regulators have no legal authority and can only call for best endeavor practices, IATP believes that IOSCO should advise the G-20 ministers to agree on a mandate for IOSCO and other relevant international organizations to provide

recommendations on the prevention of excessive speculation. Whereas enforcement of rules against market manipulation faces the very steep burden of proof of demonstrating trader intentionality, the prevention of the excessive speculation that causes widespread damage to the real economy[15] can be accomplished without demonstrating intentionality. Indeed, both HFT and algorithmic trading minimize intentionality, or at least generate so much trade data as to make a demonstration of intentionality very, very difficult to prove. However, market surveillance of commodity contract specific position limits on a per–trading entity trading basis to prevent excessive speculation is not only technologically feasible but economically desirable, insofar as IOSCO and other organizations advising the G-20 finance ministers want to ensure that the financial services industry serves the real economy (p. 3). Of course, the setting of position limits to ensure adequate liquidity for commodity contracts and the enforcement of those limits to prevent disruptions of price discovery for bona fide hedgers is not the only means to prevent excessive speculation.

To the extent that HFT impedes price discovery by providing excessive liquidity that induces volatility, rather than managing price risk resulting from fundamental factor volatility, IOSCO should provide the G-20 finance ministers with policy options to prevent HFT triggered volatility. IATP believes that a number of the recommendations provided by the IOSCO panelists on HFT will be useful, provided that they are oriented towards the prevention of excessive speculation, rather than applied to the less numerous and more difficult to prosecute cases of market manipulation.

Responses to some of the questions posed in the Report

> *Q. 2 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?*

IATP sees no reason why proprietary trading firms, including HFT firms, should not be required to apply for authorization to trade. Insofar as HFT firms are trading on their own account, as well on behalf of clients, we assume they would be subject to the good business conduct standards, margin collateral and capital reserve requirements of swaps dealers.

> *To what extent do your answers differ if the proprietary trading firm accesses the market as the customer of an intermediary firm through DEA*[Direct Electronic Access] *(i.e., under that intermediary's trading rules/codes) rather than as a direct member of the market itself?*

Assuming that the access to the market is authorized by the intermediary firm, registration requirements would remain the same as suggested above with the addition of terms of registration that would enable more frequent market surveillance of an HFT indirectly accessing the market, to ensure that the indirect access remains authorized by the intermediary firm. If the HTF applicant for registration had in the past accessed markets indirectly without intermediary authorization, the regulator may impose higher margin collateral and capital reserve requirements for a specified period of time.

> *Q. 4To 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)?*

Although we do not believe that circuit breakers or limit-up/limit-down systems will prevent

excessive volatility if HFT and algorithmic trading remain unregulated, they have reduced the extent of volatility and should be mandated. These price control mechanisms should be harmonized across trading venues and should be designed by regulators in consultation with venue operators, and subject to periodic review of their effectiveness. The mechanisms should be designed with regard to the specific characteristics of an asset class, both its derivatives and the underlying asset.

> *Q. 6 Do you have suggestions for improvements to regulators' surveillance capabilities with respect to the markets and modern trading techniques? Please elaborate.*

Exchange managed position accountability has been failure in U.S. commodity markets for at least the past decade. Since exchanges began to market their own over-the-counter products and since they ceased to be cooperatives and public utilities, their fiduciary imperative to maximize trading volume at almost any cost to the real economy has removed any economic incentive for the exchange to enforce position limits on its commodity contracts. If, as a result of derivatives reform legislation, OTC products are pushed on to regulated exchanges, but exchanges continue to "self-regulate" position accountability, regulators will continue to lack a crucial normative tool. Without spot month and aggregate position limits, regulators will not be able to quantify whether excessive speculation is occurring and if the extent of excessive speculation is disrupting price formation and orderly markets in commodities. The surveillance capabilities of regulators require not merely more super-computers and train personnel to process more uniform, timely, comprehensive and accurately coded trading data from expanding markets, but normative standards that can be enforced to prevent market abuses, as the financial service industry's products and trading practices evolve.

> *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.*

The huge increase in trade volume resulting from HFT and algorithmic trading practices requires increased funding for effective regulatory surveillance of trade data. However, there is strong resistance to adequate funding for market regulators. In the United States, Congressional defunding of regulatory agencies is among the strategies to ensure that regulators and financial reform legislation are ineffective.[16] Proposals for a fee-based regulatory system have likewise been rejected, as has any tax increase that could be apportioned for market oversight. A portion of a Financial Transaction Tax, such as that proposed by Professor Stephan Schulmeister (but rejected by most of the financial services industry, the United Kingdom and the United States, among other G-20 governments) could be invested in regulatory infrastructure to process the increasing amount and complexity of data that HFT and algorithmic trading produce. IATP does not expect that G-20 finance ministers will give IOSCO that mandate in October to propose how to finance the surveillance of the increasing volume and complexity of trade data generated by HFT and algorithmic trading. However, IOSCO could usefully gather, analyze and publish data from its member governments concerning the cost to governments of directly recapitalizing the financial services industry through direct grants and of indirectly assisting the industry by such means as reclassifying investment banks as depository institutions eligible to borrow at the lowest interest rates backed by central banks. For example, the recent U.S. General Accountability Office report on Federal Reserve Bank assistance to specific private financial firms might be adduced in a cost benefit analysis relative to investments in market surveillance infrastructure and personnel.[17] Such a report would provide a basis for the cost-benefit analysis of regulation demanded by opponents of the Dodd-Frank and European Commission reform legislation.

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

Yes. Requiring purchase of privileged access to data feeds at co-location services violates the principles of fair and non-discriminatory access.[18]

Conclusion

IATP wishes to thank IOSCO for the opportunity to comment on this valuable consultation paper. We look forward to further such opportunities, preferably with more advance notice than was allowed by the tight schedule for IOSCO's report to the G-20 financial ministers.

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[1] For more information on the Commodity Markets Oversight Coalition, see http://www.nefiactioncenter.com/commoditymarkets.php

[2] http://www.iatp.org/documents/excessive-speculation-in-agriculture-commodities

[3] E.g. Letter of Tom Buis, National Farmers Union to the U.S. Commodity Futures Trading Commission , May 7, 2008 http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/event042208_buis.pdf abd presentation by Buis to the Agricultural Commodities Roundtable, U.S. Commodity Futures Trading Commission, April 22, 2008. http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/event042208_buis.pdf

[4] E.g. Josef Schmidhuber, "Price trends of agricultural and energy commodities: links and impacts on developing countries," North-South Dialogue on Food Security and Energy Security, June 17, 2008.

http://www.southcentre.org and "Hunger on the rise." Food and Agriculture Organization, September 17, 2008 http://www.fao.org/newsroom/common/ecg/1000923/en/hungerfigs.pdf

[5] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf , p. 6. All subsequent citations are in parentheses in the comment text.

[6] Dennis Kelleher and Wally Turbeville, Comment on "Proposed Interpretive Order: Anti-disruptive Practices," Better Markets, Inc., May 17, 2011. http://www.bettermarkets.com/assets/pdf/CFTC-Antidisruptive-Practices-Interp-Order-5-17-11.pdf

[7] Jack Farchy, "Nervy investors dump commodities," *Financial Times*, May 7-8, 2011.

[8] "Potential financial stability issues arising from recent trends in Exchange Traded Funds," Financial Stability Board, April 12, 2011, 3. http://www.financialstabilityboard.org/publications/r_110412b.pdf

[9] Ibid., 3.

[10] "Price formation in financialized commodity markets: The role of information," United Nations Conference on Trade and Development, June 2011, 43. http://www.unctad.org/en/docs/gds20111_en.pdf

[11] "Position limits on derivatives," Better Markets, Inc., March 28, 2011, 12-13. http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf

[12] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD324.pdf , 3

[13] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD340.pdf, 7.

[14] "Commodity Markets Volatility and Food Security: A Contribution by Brazil," February 24, 2011.

[15] E.g., Michael Masters and Adam K. White, "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens," February 4, 2009. http://accidentalhuntbrothers.com/

[16] Steve Suppan, "Some impediments to fulfilling G-20 economic governance commitments with examples of U.S. opposition to regulation affecting commodity markets," an input to a public symposium of the UN Conference on Trade and Development, June 6, 2011. http://www.iatp.org/files/2011.6.6%20SSuppan%20UNCTAD.pdf

[17] "Federal Reserve System,: Opportunities Exist for Improving Policies and Processes for Managing Emergency Assistance," General Accountability Office, July 21, 2011. http://www.gao.gov/products/GAO-11-696

[18] See Kelleher and Turbeville, *Op cit.* for a more extended rationale for this response.