bankenverband
BUNDESVERBAND DEUTSCHER BANKEN

Comments of the Association of German Banks on "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency – Consultation Report" of the Technical Committee of the International Organization of Securities Commissions

12 August 2011

We would like to thank IOSCO for giving us the opportunity to comment on the consultation report "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency" dated 5 July 2011. Before making some general remarks and answering the 14 questions posed in the report, we would like to point out that, even though we understand the external time pressure on IOSCO's work in this field, we consider it very unfortunate that consultation on a topic so high on the public and political agenda has been limited to a mere five weeks over the summer.

General remarks

- We welcome the consultation paper and support IOSCO's task, mandated by the G20, of developing recommendations to promote markets' integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments.
- Technological innovation is an important driver of financial market efficiency.
- As the consultation paper rightly points out, HFT is not a single strategy but rather a set of technological arrangements. Many strategies involving HFT are nothing new to the markets. HFT-based strategies generally contribute to market liquidity and therefore to the efficiency of financial markets. Hampering these strategies by introducing inappropriate regulation or imposing excessive burdens on their underlying business models may trigger unforeseen and counterproductive effects on market quality.
- The discussion of HFT often focuses unduly on the US flash crash. The flash crash was not triggered by HFT but by circumstances specific to the interlinked market structures in the US. We would like to emphasise that there are effective mechanisms in place to prevent such market disruption in Germany and Europe.
- Gaming: There seems to be a public perception that HFT offers traders a sort of "free lunch" because they can exploit their edge over slower participants to make profits without any risk. This is a misconception. All strategies, including those using HFT, are based on probabilities and estimates of future developments and the actions of other market participants. If these estimates prove wrong, the strategy will not be profitable.

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?

Electronic trading is long established in the financial services industry. Technological changes have brought many positive effects for all market participants. Orders are increasingly being generated by computers. High frequency trading (HFT) is a product of the natural evolution of financial markets, not a totally new phenomenon. The change from floor trading to electronic order books and the switch from paper to electronic settlement were also driven by technological developments and have unquestionably improved the efficiency of financial markets.

In Europe, MiFID was an important catalyst for change in the market structure. MiFID was very successful in bringing more competition to securities trading. The problem of fragmented liquidity – an unavoidable side effect of this positive development – is effectively mitigated by HFT because it minimises the price differences between the trading venues, thus promoting an integrated and efficient European financial market.

HFT-based strategies generally contribute to market liquidity and therefore to financial market efficiency.

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?
We see no need to extend authorisation requirements for proprietary trading firms.

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?
We do not see a need for further regulation in this area as current risk controls are appropriate and sufficient. Banks and investment firms are authorised, registered entities and as such are subject to very strict European and national regulation, including capital, organisational and risk management requirements.

In addition to these regulatory measures, a lot of best practices are applied to HFT. Every algorithm has a dedicated trader, who continuously monitors the performance of the algorithm on trading venues. The trader can halt the algorithm or adjust it in a large number of ways to changing market conditions (there are often over a hundred possible individual adjustments). Before an algorithm goes live in markets, vigorous back testing is carried out to ensure its stability and correct behaviour.

Algorithms used by banks' clients are subject to strict agreements between the bank and the client. Risk limits are agreed, with warning thresholds set well below these limits (e.g. at 50% or 75%). If an initial threshold is breached, the bank will contact the client in person to discuss

the next steps and precautionary measures. As soon as further limits are reached, trading by this client can be fully or partially suspended until the risk level has reverted to that agreed.

Most trading venues have rules regarding the risks taken by members. Clearing houses, for example, have internal risk controls that are close to real time. If margin calls are not met, trading for the member in question is suspended.

Given the risk management measures already implemented by banks and trading venues, we do not think that regulators should introduce additional measures relating specifically to the use of algorithmic trading.

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)?
We believe that trading control mechanisms can be very effective in preventing erratic price movements. But the set-up and combination of mechanisms are key to their effectiveness. As we see it, a flash crash type incident would not be possible in Germany (or Europe) because of the automatically triggered volatility interruptions. The optimal combination depends on specific market characteristics. In consequence, imposing a one-size-fits-all mechanism is not a sensible way forward.

A more appropriate approach, in our view, would be to set a generic minimum standard for all trading venues while leaving its exact implementation to the individual venue, market dynamics and innovation.

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?
We believe that trading venues themselves are best placed to establish market making rules that suit the needs of the individual market. Market maker schemes should remain a competitive tool for venues.

We agree that stub quotes should not be allowed. They do nothing to support the provision of liquidity. The executions during the flash crash occurred as a result of stub quotes. However, stub quotes are a symptom rather than the root of the problem (as market makers were obliged to provide quotes at all times). We think a combination of market making rules

and volatility breaks are a sensible means of handling volatile markets. Moreover, trading venues should have in place clear definitions of erroneous trades.

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.

It is clear that adequate surveillance mechanisms need to be in place to maintain the integrity of markets and prevent market abuse and that surveillance authorities should have all necessary capabilities to carry out their role. Surveillance costs should be borne by trading venues and/or market participants.

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 see no direct connection between HFT and settlement failures or indiscipline. At the end of a trading day high frequency traders tend to have a flat or near flat position. There is thus no settlement instruction at all or one that is quite small in volume. High frequency traders therefore normally display a very high level of settlement efficiency.

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.

We believe potential conflicts of interest are adequately managed in the European context. MiFID requires all investment firms to have effective organisational and administrative arrangements in place which enable them to take all reasonable steps to prevent conflicts of interest from adversely affecting the interests of their clients. This includes disclosing the general nature and sources of any conflicts of interest to the client before undertaking business on its behalf.

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?

Yes, we consider existing laws and rules on market abuse in Germany and the EU to be appropriate. Surveillance authorities are thus able to detect illegal activities. Whether or not HFT infrastructures are used is irrelevant in this context. We therefore do not agree that

technological advantages allow HFT firms to engage in abusive practices on a larger scale than would be possible in a high-latency environment. Nevertheless, it must be ensured that illegal practices invariably remain prohibited.

We would like to point out that in any event, traders are involved in all order-generating processes. Algorithms and/or automated trading mechanisms are a means of helping traders reach their trading objectives. As a result, there is a clear connection between orders generated by algorithms and the person who is responsible for trading (identified by the trader ID). There is no anonymity in this regard, so disorderly trades can be clearly traced to the person responsible. Please also see our reply to question 3.

Q10 Are there any strategies employed by HFT firms that raise particular concerns? If so, how would you recommend that regulators address them?
Any form of market abuse or manipulation raises concerns. But as mentioned in our reply to question 9, we do not regard speed (of HFT) as abuse per se. Market abuse needs a strategy and HFT is simply a means of using technology to facilitate various strategies. In addition, it is human beings who are responsible for financial market abuse, irrespective of what technology they use in the process. HFT in itself should therefore not be considered a potential mechanism for market abuse since the same could be said of all forms of technology.

Permitting flash orders would be a cause for concern because it gives certain market participants an unfair advantage over others. Under European law flash orders are forbidden.

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?
Trading venues are already free to limit the volume of orders or to charge for them. It should be at the discretion of market operators to charge per message or for a high order-to-trade ratio. Some market operators already do so indirectly in their pricing policies. Restricting market operators' freedom to compete by imposing a minimum level of fees would not be beneficial to the market. Market operators have a strong incentive to manage system load adequately. There is thus is no need to intervene with regulation.

Q12 Should market operators be required to make their co-location services available on a fair and non-discriminatory basis?
Yes, and this is already required in Europe.

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?

It is not necessary to set up specific requirements in this regard. Due to high competition among trading venues, they all offer participants the possibility to stress test algorithms already. How those testing environments are designed should be left to venues and participants to decide.

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?

No comment.