

MEMO# 25546

October 7, 2011

ICI Letter on ESMA Consultation on Guidelines for Systems and Controls in a Highly Automated Trading Environment

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 60-11
INTERNATIONAL MEMBERS No. 48-11
INTERNATIONAL INVESTING SUBCOMMITTEE No. 16-11
SEC RULES MEMBERS No. 121-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 43-11
ETF ADVISORY COMMITTEE No. 65-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 73-11 RE: ICI LETTER ON ESMA
CONSULTATION ON GUIDELINES FOR SYSTEMS AND CONTROLS IN A HIGHLY AUTOMATED
TRADING ENVIRONMENT

As we previously informed you, the European Securities and Markets Authority (“ESMA”) issued a consultation paper on draft guidelines relating to organizational requirements for trading platforms and investment firms in a highly automated trading environment. [\[1\]](#) Attached is ICI’s letter on the Consultation. The letter strongly supports the issuance of the Consultation and reiterates many of the comments made in prior ICI letters on other proposals and consultations related to automated trading including several focusing on the reform of the structure of the European financial markets.

Organizational Requirements for Trading Platforms and Investment Firms in a Highly Automated Trading Environment

The Consultation sets out draft guidelines for organizational requirements for trading platforms and investment firms to address electronic trading systems, fair and orderly trading and market abuse. The Consultation notes that the draft guidelines are separate from the work the European Commission is doing to revise the Markets in Financial Instruments Directive (“MiFID”) and will operate under the existing legal framework provided by MiFID. The letter state states that ICI believes it is appropriate to introduce guidelines at this time, before the current review of MiFID is complete, given the

significance of issues raised by automated trading and regulatory developments in this area. The letter notes that automated trading has impacted the manner in which funds trade; funds must now take into account: the impact of the increase in volume of trading attributed to high frequency traders and the significant amount of automated trading in general; fragmentation in the markets and the number and types of alternative trading venues available; and new tools available to funds when trading.

Organizational Requirements for Electronic Trading Systems

The letter strongly supports establishing guidelines that address key issues related to organizational requirements for electronic trading systems such as governance, testing, recordkeeping, and cooperation with regulators and adds that a robust compliance and risk management program is critical given the prominence of automated trading. The letter also supports subjecting algorithms to appropriate rules and controls, such as requirements for policies and procedures aimed at preventing algorithms from operating in an unintended manner. At the same time, the letter states that regulators must be careful not to impede funds' use of new and innovative trading tools. The letter notes that it is critical that trading platforms and investment firms inform regulators about significant incidents that may affect the operations of automated trading systems and algorithms and cooperate with regulators to address risks.

Organizational Requirements to Promote Fair and Orderly Trading

The letter supports the implementation by trading platforms of proper risk controls and arrangements to mitigate the risk of errors generated by automated trading including arrangements to intervene in trading, or to halt trading in individual or multiple financial instruments, when necessary, on both an automatic and discretionary basis, to maintain an orderly market. Similarly, the letter supports guidelines for investment firms that cover erroneous order entry, risk management, and operational risk such as arrangements designed to prevent fraud by employees. The letter adds that disclosure of information to investors cannot be discounted when considering requirements to promote fair and orderly trading and recommends that regulators examine the sufficiency of information provided by trading venues to investors about trade execution, including whether investors are receiving adequate and accurate information about how orders are handled and routed.

Organizational Requirements to Prevent Market Manipulation

The letter states that guidelines intended to prevent market manipulation are critical for efficient markets and investor confidence. The letter notes that some trading practices utilized by automated trading firms may pose problems for long-term investors. The letter therefore supports action by regulators to clearly define practices that may constitute market manipulation to ensure adequate regulatory consequences for these practices. The letter also strongly supports an examination by regulators whether any new regulations are necessary to address certain trading strategies that should be considered as improper or manipulative and urges regulators to address issues relating to abusive or disruptive trading on an expedited basis. Finally, the letter strongly supports regulators having access

to accurate, timely and detailed information about market participants and trades that are executed to enable regulators to monitor the activities of firms, ensure compliance with MiFID, and monitor for market abuses.

Organizational Requirements for Direct Market Access and Sponsored Access

The Consultation notes that the increasing sophistication of trading technologies has meant that firms can now access markets and place orders with greater independence, speed and reduced cost. The Consultation states, however, that when firms allow their trading IDs to be used by other firms, it can pose potential risks not only to the intermediary firm, but to other firms throughout the trading chain. The Consultation therefore provides a set of guidelines to ensure that adequate risk control measures are in place to address the primary risks arising from direct market access and sponsored access arrangements.

The letter states that the establishment of robust pre- and post-trade risk controls is critical given the prevalence of high frequency trading and algorithmic trading, significantly the implementation of controls designed to manage the risks associated with market access. The letter therefore supports requiring investment firms that provide sponsored access to have in place robust risk controls and filters to detect errors or attempts to misuse facilities but recommends that the scope of any regulations in this area not impair the confidentiality of fund trading information.

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[Attachment](#)

endnotes

[1] Consultation paper: Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities (July 20, 2011) ("Consultation"). The Consultation can be found on ESMA's website at <http://www.esma.europa.eu/popup2.php?id=7675>.