INVESTMENT COMPANY INSTITUTE

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

[25361]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 48-11
INTERNATIONAL MEMBERS No. 34-11
INTERNATIONAL INVESTING SUBCOMMITTEE No. 11-11
SEC RULES MEMBERS No. 94-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 34-11
ETF ADVISORY COMMITTEE No. 53-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 61-11 RE: ESMA CONSULTATION ON GUIDELINES FOR SYSTEMS AND CONTROLS IN A HIGHLY AUTOMATED TRADING ENVIRONMENT

The European Securities and Markets Authority ("ESMA") has issued a consultation paper on draft guidelines relating to organizational requirements for trading platforms and investment firms in a highly automated trading environment. [1]

The Consultation first discusses the draft guidelines in the context of ESMA's overall work on market structure issues. The Consultation notes that secondary trading in financial instruments carries a number of risks that can threaten the regulatory objectives of investor protection, fair and orderly trading, efficient price formation, financial stability and prevention of behavior undermining market integrity. The Consultation recognizes that these risks are inherent to trading and also exist when trading is done on a person-to-person basis or over the telephone. The Consultation states, however, that in a highly automated trading environment, the organizational arrangements required by trading platforms and investment firms should be tailored to the scale, sophistication and speed of the trading activity that is now taking place and should keep up with the challenges posed to the regulatory objectives.

The Consultation therefore 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 also sets out draft guidelines relating to direct market access and sponsored access. [2] The Consultation states that ESMA expects to issue final guidelines at the end of 2011.

The Consultation notes that the draft guidelines are separate from the work the European Commission is doing to revise MiFID and will operate under the existing legal framework provided by MiFID. ESMA recognizes that the guidelines may need to be adapted to a revised version of MiFID but the Consultation states that ESMA believes that given the importance of the issues raised by automated trading, regulatory developments outside the EU and the fact that authorities are already seeking to deal with trading issues within the existing MiFID legal framework, it is appropriate to introduce guidelines prior to any MiFID revision. [3]

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

The Consultation notes that trading in financial instruments has come to rely increasingly on the use of electronic trading systems and that an important aspect of developments in this area has been the rise of high frequency trading. The Consultation describes some of the benefits of a highly automated trading environment but also notes that several concerns have been expressed about trading in such an environment including whether the trading activities that the environment has facilitated, such as high frequency trading, adversely affect the quality of markets and whether highly automated trading leads to disorderly trading conditions. The draft guidelines seek to control the risks that arise from trading in a highly automated trading environment and cover three specific areas: electronic trading systems, fair and orderly trading and market abuse.

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. Direct market access and sponsored access offer market participants a more direct or independent route to the markets than conventional trading through an intermediary and in doing so provides latency advantages as well as other key advantages such as trading anonymity. [4]

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. Specifically, in the absence of proper controls, a firm using another firm’s trading name may lack incentives to behave in a way that would limit reputational risk to the firm whose name it is using or to ensure that its actions do not jeopardize the ability of a firm to clear trades or for a trading venue to function in an orderly manner. 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.

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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. ESMA will consider all comments received by October 3, 2011.

[2] There are separate standards in each of these areas for trading platforms (i.e., regulated markets and multilateral trading facilities) and investment firms executing orders on behalf of clients and/or dealing for their own account.

[3] The Consultation states that while the market structure in Europe differs from that in the Unites States, it is clear that many of the concerns that U.S. regulators raised in the wake of the flash crash about trading in a highly automated environment are also relevant to Europe.

[4] The Consultation describes direct market access and sponsored access as essentially involving one firm, the intermediary, which is a market member, allowing another firm, which is not a market member, to use its trading ID at a trading platform to place its trades directly or indirectly in the market.