

MEMO# 25338

July 18, 2011

IOSCO Consultation on the Impact of Technological Changes on Market Integrity and Efficiency

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 43-11

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ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 29-11

ETF ADVISORY COMMITTEE No. 46-11

CLOSED-END INVESTMENT COMPANY MEMBERS No. 52-11 RE: IOSCO CONSULTATION ON THE IMPACT OF TECHNOLOGICAL CHANGES ON MARKET INTEGRITY AND EFFICIENCY

The Technical Committee of the International Organization of Securities Commissions (“IOSCO”) has published for public comment a consultation report analyzing technological developments in the financial markets and their impact on, among other things, market structure and market participants’ behavior. [\[1\]](#) The Report specifically discusses, and requests comment on, issues that IOSCO has not previously examined including proper market risk controls and trading controls, regulatory surveillance capabilities, conflicts of interest, fee structures, and co-location. The Report also includes a general discussion on market structure developments that have arisen from technological change including algorithmic trading, market fragmentation and dark liquidity, direct electronic access, and tick sizes. The goal of the Report is to develop recommendations to mitigate the risks posed by technological developments.

High Frequency Trading

The Report focuses on developments relating to high frequency trading. Most significantly, the Report discusses the impact of high frequency trading on the financial markets and the risks posed to market integrity and efficiency. The Report notes that empirical evidence on the impact of high frequency trading on the financial markets is still scarce due to a limited availability of appropriate data and that academic literature to date has mainly focused on

measures of liquidity, price discovery and volatility rather than on risks to the integrity of the markets as a whole.

The Report groups the risks posed by high frequency trading into several areas including risks to: (1) the efficiency of the markets; (2) the fairness and integrity of the markets; and (3) the stability and resiliency of the markets. The Report states that risks to the efficiency of the markets include concerns regarding the quality of the price discovery process in the context of a growing share of trading accounted for by high frequency trading firms as well as the quality of liquidity provided by these firms. Risks to the fairness and integrity of the markets include whether access to technological infrastructures is offered in a fair way, whether high frequency trading enables the pursuit of practices that may result in harm to market quality, and whether technological advantages offer high frequency trading firms the possibility of engaging in abusive practices on a larger scale than would have previously been possible. Risks to the resiliency and stability of markets include algorithms that behave in an unexpected way, capacity challenges posed by the high technology requirements of high frequency trading, and whether trading venues and intermediaries have systems and controls appropriate for a high frequency environment.

Regulatory Tools to Address Technological Developments

The Report includes an extensive list of possible new regulatory tools to address technological and market developments. Many of these regulatory tools have already been implemented in the United States such as requirements for new pre-trade risk controls, circuit breakers or limit-up/limit-down mechanisms, common trade cancellation arrangements across markets, mandatory minimum criteria for registered market makers, and banning flash orders.

Other suggested new regulatory tools relate to proposals that have been introduced or that are being discussed in the United States such as the need for tailored regulatory requirements for high frequency trading or algorithmic trading, whether high frequency trading or algorithm traders should provide for specific forms of stress testing and internal sign-off processes for new algorithms, assessing whether specific charges, fees or taxes on high order entry and cancellation rates should be introduced; considering the introduction of minimum tick sizes and minimum order book resting time, and evaluating what could be done to improve market surveillance. The Report asks a series of specific questions for public comment on these potential new regulatory tools.

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endnotes

[1] “Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency”, Technical Committee of the International Organization of Securities Commissions, July 2011 (“Report”). The Report can be found on IOSCO’s website at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf>. The consultation period for the Report will close on August 12, 2011.

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