

MEMO# 25397

August 9, 2011

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

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 51-11
INTERNATIONAL COMMITTEE No. 20-11
INTERNATIONAL INVESTING SUBCOMMITTEE No. 12-11
SEC RULES COMMITTEE No. 69-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 35-11
ETF ADVISORY COMMITTEE No. 56-11
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 40-11 RE: DRAFT ICI LETTER ON
IOSCO CONSULTATION ON THE IMPACT OF TECHNOLOGICAL CHANGES ON MARKET
INTEGRITY AND EFFICIENCY

As we previously informed you, the International Organization of Securities Commissions' ("IOSCO") has issued a consultation requesting comment on a number of issues raised by the impact of technological changes on market integrity and efficiency ("Consultation"). Attached is ICI's draft letter on the Consultation. The draft letter strongly supports IOSCO's review and provides comments on a wide variety of issues including high frequency trading ("HFT"), pre- and post-trade risk controls, trading control mechanisms, regulators' surveillance capabilities, and minimum requirements for market makers.

Comments are due to IOSCO no later than this Friday, August 12. If you have any comments on the draft letter, please contact Ari Burstein by email at aburstein@ici.org or by phone at 202-371-5408 by COB Thursday, August 11.

Impact of Technological Developments on Fund Trading

The draft letter notes that funds rely heavily on technology for the efficient execution of their trades and that technological developments have had a significant impact on the manner in which funds trade. Specifically, when determining the most efficient approach to executing a trade, the draft letter states that funds must take into account: (1) the impact of the increase in volume of trading attributed to certain market participants such as high

frequency traders and the significant amount of automated trading in general; (2) fragmentation in the markets and the amount of, and types of, alternative trading venues available; and (3) the new tools available to funds when trading.

The draft letter states that funds also have become more diligent in choosing their counterparties and the venues to which they route their orders to protect the confidentiality of information regarding their trades. Technological developments also have resulted in the reduction of posted liquidity and average execution size while increasing the difficulty of trading large blocks of stock, driving more fund orders away from the lit markets towards the use of dark liquidity. The draft letter notes that, at the same time, technological developments have resulted in improvements to the sophistication of the trading functions available to investors.

Regulatory Obligations on HFT Firms/ Mandatory Minimum Criteria for Market Makers

The draft letter states that the Consultation's suggestion that all HFT firms that are not currently subject to registration by a regulator be required to obtain such registration could prove beneficial. Subjecting these firms to further regulation in this manner, at least those over a specified minimum quantitative threshold, would ensure that they are subject to systems and risk management requirements and critical regulatory oversight, as well as provide regulators with better access to information about HFT firms. Given the critical role of liquidity, and liquidity providers, in the markets, the draft letter also recommends that regulators examine whether more stringent obligations are necessary for traditional market makers in times of market stress.

Pre- and Post-Trade Risk Controls/ Trading Control Mechanisms

The draft letter states that the establishment of robust pre- and post-trade risk controls for the markets is critical given the prevalence of algorithmic trading and high frequency trading. The draft letter notes that ICI strongly supported proposals by the SEC to implement risk management controls and supervisory procedures designed to manage the risks associated with market access. The draft letter also notes that ICI strongly supported efforts to initially address market volatility through the establishment of single-stock circuit breakers, as well as the establishment of a limit up-limit down system to replace the single-stock circuit breaker pilot. The draft letter supports the implementation of similar rules by other jurisdictions.

Regulators' Surveillance Capabilities

The draft letter states that to be able to monitor trends in trading and trading behavior, it is important that regulators have access to accurate, timely and detailed information about market participants and the trades that are executed in the markets. The draft letter strongly supports an examination by regulators of transaction reporting regimes similar to the consolidated audit trail and larger trader reporting initiatives in the United States.

Rules on Market Abuse and Disorderly Trading

The draft letter 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 activity and urges regulators to address issues relating to abusive or disruptive trading on an expedited basis.

HFT Strategies

The draft letter states that many of the strategies utilized by HFT may pose problems for long-term investors. The draft letter notes that there is nothing illegal per se about many of these strategies but that merely because this behavior is not per se illegal does not mean that these strategies are beneficial to the markets or to investors. The draft letter supports action to clearly define practices involving HFT and algorithmic trading strategies that may constitute market abuse.

Cancelled Order Fees

The draft letter recommends that regulators act to address the increasing number of order cancellations in the financial markets. At the very least, regulators should examine whether requirements should be put in place to restrict certain types of orders in specific contexts, or whether a fee should be imposed on cancelled orders.

Co-Location Services

The draft letter notes that in the United States, the SEC has taken the position that the terms of co-location services offered by exchanges must not be unfairly discriminatory and that fees must be equitably allocated and reasonable. The draft letter states that these represent standards by which regulators can judge co-location services offered by trading venues.

Stress Testing Algorithms

The draft letter states that the increased use of algorithms has raised several regulatory concerns including algorithms that may act in an unexpected or unintended manner leading to sudden liquidity imbalances that quickly drive prices up or down. The draft letter 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.

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[Attachment](#)

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