29 April 2010

Consultations www.cesr.eu

Dear Sir

Call for Evidence: Micro-structural issues of the European equity markets

The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail and investment banks and life insurers, and the managers of occupational pension schemes. They are responsible for the management of over £3 trillion of assets (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds such as pensions and life funds and a wide range of pooled investment vehicles.

IMA members manage around £820bn. in European equities as at the end of 2008 and therefore have a keen interest in market structure issues and how changes can affect the way they handle orders on behalf of their underlying clients.

We welcome the opportunity to comment on CESR's call for evidence although our members are not in a position to provide detailed answers to some of the more technical questions. We would however make the following high level points:

1. *High Frequency Trading*

IMA members view HFT as another source of potential liquidity and as such vary from being agnostic to slightly positive or slightly suspicious of the benefits to their clients of the proliferation of HFTs. On the one hand HFTs can give them additional choice as to where they might execute client orders. Some observers have commented that because HFTs are paid to post liquidity that they are extracting an unwarranted price from end-investors. IMA members recognise that there is always a price to be paid for liquidity and that it is not clear whether HFTs are profiting unfairly. Beyond anything it would be good to have some better evidence of true volumes and impacts.

Over the last few years the buy-side has taken a far more hands-on approach to deciding how and where their client orders are executed which has therefore led them to investigate to a far greater extent exactly what sort of venues and liquidity providers they use. To that extent therefore greater choice is important in the search for best execution. It is the case however that HFTs generally transact orders of a size far below that which would interest our members who tend to look for natural and larger sized business elsewhere. HFTs are viewed however as part of

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the whole market which has evolved under MiFID and IMA members increasingly need the flexibility to trade away/avoid interaction with some venues/arbitrage flow.

HFTs cannot be considered separately from the dark/lit debate. It would be wrong to force a greater volume of institutional business onto the lit markets where it would have to interact directly with HFTs. Equally HFTs should not be thought of as driving all business away from the lit markets; it is as said at the beginning a matter of choice. Asset managers need to trade with their eyes wide open and to ensure their strategies protect them as best as they might against any form of gaming or unwanted HFT interaction. Where the balance of available liquidity set against the possible additional costs which arise if an order result in many more trades, means it is in the interest of their clients to access a venue on which HFT trading is prevalent, then firms will do so. How that order is sliced and presented to the market today will differ from when there was less HFT.

What is perhaps more of a concern than the immediate transactional impact of HFTs is that the market infrastructure appears to developing, and so allocating resource, in a manner dictated by the needs of the HFTs. The dependence of any organised markets for the fees and related data profits that arise from the volume of activity generated by HFTs has meant their own interests are more aligned with preserving such activity. Equally this has meant that some competitor venues specialising in the needs of institutional investors have become more attractive, since the HFTs cannot access them.

We presume as well that despite it being said that HFTs add to liquidity they are not seen as market makers and therefore need not be regulated by MiFID. Does CESR consider that it can obtain necessary transaction data from them and that they are subject to appropriate standards compared to investment firms?

IMA members believe that higher quality post-trade data, particularly from dark pools, is the key to understanding where best to transact business. This is a clear priority.

2. Indications of Interest

When considering IOIs, it is important to be clear as to what is included and what not. As you mention in your call for evidence, the SEC are also looking at IOIs. The term "actionable IOIs" is not always helpful as it appears to suggest that the IOI itself can be interacted with so as to form a trade.

If there are systems in existence in which a so-called IOI can be directly "hit" so forming a contract for the sale or purchase of securities, then it seems to us beyond doubt that such an IOI is itself a bid or offer. Furthermore that system may in itself constitute an MTF. There is, in our view, adequate existing regulation to cover such a circumstance.

IOIs are marketing communications in the terms of MiFID. They ought therefore to be subject (when published by an investment firm, including those operating an MTF) to the obligation to ensure that such communications are fair, clear and not

misleading[1]. Additionally the Market Abuse Directive itself addresses communications that may be misleading. If therefore such IOIs are used to mislead the market or are consistently inaccurate to an extent that shows that the publisher is taking no or little care, then again we consider that there are adequate existing regulations which could be enforced by local supervisors.

What we understand the SEC to term as an "actionable IOI" is not as such a bid or offer that can be accepted but an advert (marketing communication) about an order hidden in a dark trading system. The SEC considers that the advert will lead (almost inevitably) to an offer or bid being made by a person seeing it which will result in the order being executed in the dark trading system. In that sense the "actionable IOI" plays an analogous role to some of the functions which pre-trade transparency performs on the lit markets and draws in specific "taker" liquidity.

It is in our view important to note that the SEC proposes (if anything is to be done) to treat actionable IOIs analogously to information which is subject to pre-trade transparency obligations[2]. Therefore even in the United States the equivalent of the large in scale waiver would be applied to such actionable IOIs, though with a qualification[3]. Consistently therefore with the approach taken to pre-trade transparency in the European markets, one might expect that if the IOIs relate to trades that will take place at the midpoint cross they would therefore be entitled to reference price pre-trade transparency waiver under MiFID anyway.

There is another issue related to this question of IOIs. There may be at times a conflict of interest between the operator of the pool and the clients who are submitting orders which are then the subject of IOIs. The clients who may be the asset managers of large institutional investors may benefit from the liquidity that is attracted to the dark pool by IOIs generally and post trade transparency (which will be immediate) but will not wish their own specific order to be identified from an IOI because of fears of information leakage and consequent damage to the execution (which will occur at midpoint under current regulations and therefore can be impacted by trades reacting to the IOIs on the reference price market).

The pay-off between the general benefit of pre-trade transparency but specific damage from the consequent knowledge of a particular order is an issue seen throughout any consideration by regulators and legislators of pre-trade transparency and the nature of the waivers that ought to apply. But in this case it is open to clients to request the operator of the dark pool not to generate an IOI from their order. It is not unknown for some asset managers to instruct dark pool operators that a term of their providing orders into the dark pool is that automated IOIs should not be generated from those orders.

So long as there is this possibility of a client controlling whether or not IOIs are generated then it is possible for the asset managers to determine whether or not it

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[1] some or all of those to whom the IOI is directed will be clients or potential clients within the meaning of MiFID, even if eligible counterparties

[2] There are linked issues with the CTA but as CESR notes some of the SEC work is very specific to the US model

[3] SEC release page 9 – "Specifically, the proposed amendment to the definition would exclude any actionable IOIs "for a quantity of NMS stock having a market value of at least $200,000 that are communicated only to those who are reasonably believed to represent current contra-side trading interest of at least $200,000" ("size-discovery IOIs")".

may be in their clients' interests for an IOI to be generated automatically by a dark pool. The dark pool operator is itself subject to the requirements on conflicts of interest. Again therefore we think there is adequate existing regulation and it is a matter for investment firms (the dark pool operators and asset managers) and their clients to be clear with one another about these possible conflicts and ensure that they are managed or that the requisite disclosure and consent is obtained.

Whilst a lot is written about dark pools in relation to pre-trade transparency, in our view a key distinction between an MTF and a broker crossing network related to the ability of a broker or ways to determine to whom it may provide services whilst the MTF has to provide non-discriminatory access to all-comers. The rights and wrongs of this, and whether there should be any boundary conditions such as market share are matters properly to be considered elsewhere in the MiFID review. As such we do not think that IOIs should be treated differently; investment firms that operate dark pools should be free to advertise services to whomsoever they wish. Clearly they will be choosing from amongst their clients which itself will be a subset of the entire market. Whether they choose from within that group of clients and only show some clients and not others is a matter which we would assume is governed by their conflict of interest policy. In this regard we would note the SEC description of size-discovery IOIs mentioned at footnote 3 above. The size-discovery IOIs would need to be communicated only to those who are reasonably believed to represent current contra-side trading interest of at least $200,000. We would imagine that dark pool operators who choose to send IOIs to only some clients will likely choose those it expects may have "taker" liquidity of the requisite size; it would not be in their long term interests to ignore clients who may wish to interact with the dark order.

If it were later decided to require some dark pools at times to participate in pre-trade transparency, then CESR could revert to the issue of IOIs in the EU. For now we consider there appear to be sufficient regulatory tools available to CESR members when added to the commercial pressures and conflicts that ought to constrain how and when IOIs are used.

If you have any queries please do not hesitate to contact me.

Yours faithfully

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