

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France
www.esma.europa.eu

Chris Barnard
Germany

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**- Your Ref: Comment letter on Guidelines on systems and controls
in a highly automated trading environment for trading platforms,
investment firms and competent authorities**

Dear Sir.

Thank you for giving us the opportunity to comment on your consultation paper on Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities. The guidelines are generally reasonable, sufficient and complete in the specific context of a "highly automated trading environment". I have recently provided comments on IOSCO's consultation report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency.¹ I would like to repeat my comments on high frequency trading here, which are pertinent in the context of regulatory issues, market integrity and efficiency and then discuss some detailed points in the context of systems and controls.

High frequency trading²

The recent history of high frequency trading (HFT) is one of technological developments driving market practices and operations, and influencing the behaviour of market participants. This has both positive and negative implications. My view is that technology should not solely determine market practice, but that regulators should determine market rules that define acceptable practices in the context of market integrity and efficiency, and that technology should operate within these acceptable practices and boundaries.

¹ See <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf>, and my comment letter thereon.

² HFT is really a subset of algorithmic trading generally.

HFT has received a lot of bad press recently, some of it well-deserved.³ However, we must be careful to act discriminately here, and recognise that HFT does bring some benefits to market efficiency, as well as detrimental costs. For example, HFT can increase liquidity and reduce spreads, which is generally beneficial to market efficiency. However, it can also act to increase volatility and retard the price discovery process, which is detrimental to market efficiency.

Certain strategies, for example momentum ignition and spoofing, are or should be illegal, and therefore should be prohibited under general antidisruptive practices rules. Flash orders clearly create a two-tiered market, in which certain investors have access to information which allows them to trade unfairly. This is not dissimilar to front running, and the practice should be prohibited.⁴ Certain other practices, such as order anticipation are parasitic in nature.⁵ They do not add liquidity or aid the price discovery process, they involve no investment or hedging component, rather speculation, and in my opinion should also be prohibited. For completeness here I would suggest that markets and regulators should undertake a principles-based review of these kinds of harmful, manipulative or disruptive practices, consistently across markets and regions, and propose rules and guidance thereon where appropriate.

Systems and controls

The MiFID implementing directive and MAD provide a sufficient framework for promulgating additional and specific guidelines on systems and controls in a highly automated trading environment. For example, Article 6 of the MiFID Implementing Directive requires investment firms to establish and maintain a permanent and effective compliance function, with an appointed compliance officer. Your proposed guidelines 1 and 2 covering organisational requirements (notably for all of regulated markets', multilateral trading facilities' and investment firms' electronic trading systems) require the development and monitoring of electronic trading systems "through a governance process that embeds compliance and risk management principles". This is entirely reasonable and sufficient within the context of a highly automated trading environment, and is also consistent with MiFID.

For completeness I have some specific recommendations that could improve your proposals.

Firstly I would recommend that your proposed guidelines should specifically reference a requirement to monitor, control, manage and remediate conflicts of interest, including potential conflicts of interest, within the specific context of a highly automated trading environment. Such a requirement should be broad enough to cater for the evolving nature of technology in markets, including (but not limited to) HFT for example.

³ For example see Rise of the machines, The Economist, 30 July 2009; A Market Solution That Puts Investors in a Fix, Wall Street Journal, 24 August 2010; Rein in the Cyber Cowboys, The Financial Times, 6 September 2010; The New Speed of Money, Reshaping Markets, The New York Times, 1 January 2011; The race to zero, speech given at the International Economic Association Sixteenth World Congress in Beijing, China by Andrew Haldane, Bank of England Executive Director of Financial Stability, 8 July 2011.

⁴ See SEC File No. S7-21-09, Elimination of Flash Order Exception from Rule 602 of Regulation NMS, 2 July 2010, and my comment letter thereon.

⁵ Such practices may be detrimental, regardless whether a particular trader benefits or profits from it.

Secondly I would also recommend that your proposed guidelines should reference and require a fair, open and equal access to market facilities. Access requirements should be equitable and non-discriminatory.⁶ Furthermore, fee structures should be transparent, equitable and non-discriminatory and should not encourage, explicitly or implicitly, disruptive or abusive trading practices. These general requirements for fair, equitable and non-discriminatory practices should be considered in conjunction with overall compliance, and the general conflicts of interest provisions mentioned above.

Taking into account my comments and recommendations above, I would suggest that your proposed guidelines on systems and controls for trading platforms and investment firms should be reasonable, sufficient and complete in the specific context of a highly automated trading environment.

Yours faithfully

C.R.B.

Chris Barnard

⁶ Such a requirement should cover DMA, SA and co-location amongst other things.