April 30, 2010

CESR
11-13 avenue de Friedland
75008 Paris
France

Re: Call for Evidence of Micro-structural Issues of the European Equity Markets, Ref: CESR/10-142, dated 1 April 2010

To Whom It May Concern:

Please accept the following as a response to the Call for Evidence on Micro-structural Issues of the European Equity Markets.

Firm Introduction and Background

IMC Financial Markets ("IMC") is a Netherlands based global proprietary trading firm that is licensed and regulated by the Dutch Authority for the Financial Markets (AFM). IMC engages on the European financial markets as a bona-fide market-maker, providing liquidity for many of the European listed equities and equity derivatives. In addition, IMC is part of a global firm with affiliates trading from Chicago, Hong Kong, Sydney, and Zug. IMC appreciates the opportunity to address some of the issues raised in the Micro-structural Issues of the European Equity Markets, and hopes that its perspectives and opinions, fostered by over 20 years of global trading experience, will be useful to CESR. In fact, our Chicago based subsidiary is providing commentary on the recent SEC release on equity market structure, which touches on many of the same issues.

I. High-Frequency Trading

The proliferation of automated trading in the current market system has given rise to a new, loosely-defined category of proprietary trading firms called "high-frequency trading firms." Although there is no industry wide accepted definition of the activity, we believe it sensible to define it as all high turnover, high capacity, latency sensitive strategies in need of physical proximity to an exchange matching engine. CESR has requested comment on the role HFT firms play, the strategies they employ, and their general impact in the markets. IMC firmly believes that the presence of these professional trading firms has proven to be a positive to the integrity and efficiency of the European markets.

Market participants, including individual investors, generally benefit from competition among proprietary trading firms. Increased competition in the markets among such professional firms provides greater depth of liquidity, decreases short-term volatility and tightens spreads. The result for investors is that they are able to buy and sell at more favorable prices and with lower execution costs. Various studies performed by transaction cost providers have shown that the average institutional transaction cost has decreased substantially over the last 10 years. We believe that HFT firms have played a critical role in this development. Competition also promotes efficiency. Professional firms devote substantial resources to their exchange connectivity, pricing models, and market data, which allow them to effectively react to market inefficiencies. The benefit for all market participants is a more efficient market where pricing imbalances are corrected quickly and effectively. Similarly, competition protects

against manipulative pricing and abuse, as pricing is dictated by a greater number of professional trading firms, rather than through a few specialist firms.

The primary source of order updates in the markets stems from market making activities that proprietary firms, like IMC, employ. Proprietary firms that engage in market making use publicly available market data to submit bids and offers, thereby providing liquidity in the marketplace at specific prices. Proprietary firms engaging in market making are simply fulfilling the traditional role that exchange specialists held on manual trading floors. However, they are doing it more efficiently in a more competitive environment.

Lastly, HFT firms are firmly in favor of both transparency as well as centrally cleared exchange based transactions in all asset classes. As a result we are more aligned with the objectives of regulators and exchanges than most other market participants are. Having no access to the information inherent in client flow and having no ability to transact in an opaque OTC market we believe that HFT firms can add substantial value in the future market structure landscape as more asset classes move from the opacity of the trading desks onto the competitive exchanges, providing better pricing for all end users.

1. **Please describe trading strategies used by high frequency traders and provide examples of how they are implemented.**

   HFT trading strategies can generally be broken down into two main ones, although these do not have to be mutually exclusive:

   Market Making / Liquidity Providing :
   Market Makers / Liquidity Providers, as members of a regulated exchange are licensed and regulated entities. The role of these intermediaries is to accurately calculate the value of a tradable instrument and to disseminate two sided prices to the market in a rapid and efficient manner. Moreover, these participants need to have the ability to update many quotes in a high speed capacity to keep up with market demands.
   The economics in this activity is arrived at by the ability of the participant to capture and retain part of the spread inherent in the securities that they are active in. Besides the risk associated with this activity, other costs such as exchange connectivity, trade fees and clearing costs are all factors determining how much of this spread is retained. It is for this reason that increased competition between exchanges results in lower exchange costs which in turn leads to tighter spreads and more liquidity.

   Arbitrage:
   In these strategies, firms will trade price differentials between products that are almost perfectly correlated in the market. These products include equity with multiple listings, fungible products like ADRs and highly correlated products like futures and ETFs. These strategies provide an essential service to the rest of the market by ensuring that multiple listings are possible and prices remain consistent among different trading venues. In addition to this, these strategies add liquidity to platforms that would not ordinarily have natural liquidity themselves. They provide better and more transparent pricing and more liquidity to investors.

2. **Please provide evidence on the amount of European trading executed by HF traders (including the source(s) of that information). CESR is particularly interested in statistical material on: a) market share of HFT in orders/trades in Q1/2010 (and, if possible compared to 2008 and 2009), b) average trade size in Q1/2010 (and, if possible compared to 2008 and 2009), c) market participants, d) financial instruments traded (including cash vs. derivatives). If possible, please distinguish between HFT on transparent organised trading platforms and on dark pools of liquidity.**

Due to the anonymity of the originators of trades on most exchanges, we feel that the exchanges are the best source for this information as they can more accurately access the amount of volume that is transacted by HFT firms and possibly which portion of volume from brokers is from HFT clients versus other clients that are not latency sensitive. We do feel, however that many of the numbers that have been mentioned in Europe (40%+) are an exaggeration as more often than not algorithmic trading strategies transacting order flow are included.

3. What are the key drivers of HFT, and (if any) limitations to the growth of HFT?

The main drivers of HFT strategies are:

- The ability to manage risk efficiently by managing exposure times of open orders on exchanges.
- Liquidity,
- Auto-ex and low latency exchanges with high message capacity
- The introduction of a trade-through rule similar to the US would not only provide best execution to the end users but also reward the submission of limit orders.

Limitations:

- Market models that do not facilitate automated matching of prices in the book and give the issuer the opportunity to reject orders sent to them such as the Euronext Warrant model or many of the FX trading platforms
- Fixed transactions costs per trade. HFT strategies are most effective with variable transaction costs.
- Exchange latency and capacity

4. In your view, what is the impact of high frequency trading on the market, particularly in relation to:

- **market structure (eg. tick sizes);**

IMC believes that HFT has made a very positive contribution to the evolution of the market structure in the following ways:

- the ability of new platforms such as MTFs to compete with the existing exchanges and drive down execution costs
- the narrowing of spreads witnessed in many asset classes in recent times, which have been a result of the activities of HFT firms.
- the additional liquidity available in the marketplace by liquidity providing or arbitrage strategies.

- **liquidity, turnover, bid-offer spreads, market depth;**

See answers as provided above

- **volatility and price formation;**

Most HFT strategies do not take a view on the direction of individual securities and as a result do not create or add to volatility. In general, HFT strategies are designed trade against sudden changes in volatility which serves to either smooth or dampen volatility. HFT strategies play an essential role in price formation by adding competition in the marketplace and ensuring pricing consistency across multiple platforms and asset classes.

- **efficiency and orderliness of the market?**

HFTs have been pivotal in creating, fostering and maintaining an efficient and orderly market. HFTs are there to provide bids and offers in a competitive environment, thus ensuring superior price formation. Additionally, this competition has added to the technological developments which in turn have added to the efficiency and orderliness of the market, e.g. less human error and/or manipulation.
Arbitrage strategies will serve to eliminate pricing inefficiencies, thus adding to the orderliness and efficiency of the marketplace.

5. What are the key benefits from HFT? Do these benefits exist for all HFT trading strategies?

The benefits our laid out in response to #4.

6. Do you consider that HFT poses a risk to markets (eg. from an operational or systemic perspective)? In your view, are these risks adequately mitigated?

We do not believe that HFT poses a significant risk to the markets, either from an operational or a systemic perspective. In fact we believe that in many cases the presence of HFT reduces risk by providing an orderly market (see #4) and fostering technological development.
There is a case to be made for reviewing the exemptions that some of the exchange members enjoy in terms of regulatory oversight. We believe that the situation where some HFT firms are not properly supervised, and in some cases are large market participants can pose a degree of systemic and operational risks.

7. Overall, do you consider HFT to be beneficial or detrimental to the markets? Please elaborate.

Overall, HFTs are beneficial to the markets for all the reasons listed in #4 and 6. It should also be noted that the very existence of HFT firms has ensured that many products that would otherwise have traded in the OTC markets instead were transacted on exchanges. Recent experience has accentuated the systemic dangers to the system of the OTC markets.

8. How do you see HFT developing in Europe?

IMC believes that as exchange technology improves in terms of latency and capacity, HFT's share of the market will increase. We also believe that as regulators work to move opaque OTC products onto an exchange environment, which we applaud, HFT will be able to make a very positive contribution to the success of these efforts.
We also would applaud efforts to bring bank issued structured products (warrants etc.) into a more competitive market making environment so that the retail investors are ensured of receiving fair pricing. It cannot be a desirable situation where many of these bank-issued products are only supported by a single market maker, i.e. the issuing bank.

9. Do you consider that additional regulation may be desirable in relation to HF trading/ traders? If so, what kind of regulation would be suitable to address which risks?

We believe that consideration should be given to various new regulations concerning market access. These should include:

- Participants – ensuring that all market participants are properly supervised and regulated either as a direct exchange member or through a sponsoring broker. Particular attention should be given to regulations around the various validation processes that market participants build into their systems infrastructure. This is discussed in more detail below.

- Technical - ensuring equal and fair access to co location facilities both in terms of speed and cost. This is discussed in more detail below

II. Sponsored Access

1. What are the benefits of SA arrangements for trading platforms, sponsoring firms, their clients and the wider market?

- Clients clearly see most of the benefit of these facilities, as it provides access to exchanges at substantially lower price points than would be the case at higher touch means of access, and it ensures anonymity versus dealing with a physical intermediary. Clients tend to notice the latter benefit by the result, which is a lower footprint in terms of market impact.
- Sponsoring firms have seen very rapid commoditization of their business, in particular versus the high touch channels that these firms offer. The increased competition, in particular by non-traditional brokerage firms offering access at vastly lower price points than the traditional brokerages have been offering has resulted in a level playing field with lower barriers to entry than in the past.
- The wider market has benefited from lower trading fees resulting in more volumes and liquidity than would otherwise have been the case. Sponsored access has also lowered the barriers to entry by enabling nontraditional brokerage houses offering IT driven services to flourish and compete with the more traditional ones.

2. What risks does SA pose for the orderly functioning of organised trading platforms? How could these risks be mitigated?

IMC believes that sponsored access poses risks to the orderly functioning of organized trading platforms only insofar this access is provided with little or no risk controls built into the order management process. W e believe there is a strong case to be made for regulating these order validation procedures in for the firms providing this sponsored access.
Furthermore, IMC is of the opinion that all exchange members should be regulated entities and that all these entities need to carry the same requirements in terms of the risk controls that they have built into their systems. This will not only mitigate the risk that some of the activities bring about, but also create a level playing field for all market participants. It should be taken into account that a second set of risk checks at the Sponsor in addition to those already in place with the sponsored participant is undesirable.

3. What risks does SA pose for sponsoring firms? How should these risks be mitigated?

We refer to our answers in question 1 and 2.

4. Is there a need for additional regulatory requirements for sponsored access, for example:

a. limitations on who can be a sponsoring firm;

IMC does not believe there should be restrictions or limitations on who can be a sponsoring firm as long as these firms are subject to the same requirements in terms of order validation procedures, risk checks and client acceptance procedure.

b. restrictions on clients that can use sponsored access;

IMC believes that the responsibility lies with the provider of the service to make sure that the client using it is fit and proper and a professional client as defined by MIFID.

c. **additional market monitoring requirements;**
All of the above.

d. **pre-trade filters and controls on submitted orders.**

As stated above, IMC believes that all market participants, need to be subject to pre-trade filters to prevent credit and volume limit breaches. Then again, multiplication of pre-trade filtering should be avoided.

5. Are there other market wide implications resulting from the development of SA?

Sponsored Access has played a critical role in reducing direct transaction costs for end users as well as ensuring a greater degree of anonymity to these market participants, thereby improving the total costs of the transactions as well. Many of these developments have been made possible by technological innovation, such as algorithmic trading and latency improvements in which HFT participants have played a critical role.
There is a concern, however that the sliding fee scales adopted by many of the incumbent exchanges are providing an increasingly unfair advantage to the largest market participants. Through the sponsored access business, the volumes have become more concentrated amongst a number of large houses. IMC favors a transparent and competitive fee which is the same for all market participants, thereby creating a level playing field with low barriers to entry.

III. <u>Co-location</u>

1. What are the benefits of co-location services for organised trading platforms, trading participants and clients/investors?

Co-location helps firms minimize latencies between the servers of market participants and an exchange's matching engine. The emphasis on speed to the markets is inherent to the transformation of today's market structure brought about by automated trading. Co-location allows more trading firms access to the markets with lower latencies, thereby promoting, rather than detracting from, fair and equitable access.
There are very clear benefits co-location brings to the trading participants as well as the rest of the marketplace. Because of the great number of quotes that some of the trading participants send to the market as well as the number of updates needed, physical proximity to the exchange matching engine is of vital importance. As quotes in equity, options and futures markets have become very competitive and participants have had to narrow their bid ask spreads in order to stay competitive and continue to participate, the need for physical proximity has increased as it reduces the risk of the trading participants and enables them to provide more liquidity. There is a very clear correlation between narrow bid ask spreads and speed i.e. the need for co-location. These reduced bid ask spreads benefit the whole market place, not only those that co-locate. In the absence of co-location, spreads would widen as HFT firms would need to factor in additional risk resulting from increased exposure times.

2. Are there any downsides arising from the provision of co-location services? If yes, please describe them.

The main downside to providing co-location services is if the service is not provided in a transparent or fair manner. If for example rack space is limited and therefore very expensive and the allocation process

is not transparent or fair. This may advantage the larger trading participants unfairly and pose barriers to entry for new trading participants. The situation where there is no co-location offered at all is still much less desirable for example in markets like Korea. This gives a very big advantage to brokers that happen to be located nearest to the exchange's matching engine.

3. **What impact do co-location services have on trading platforms, participants, and the wider market?**

   As per question 1, co-location services enable trading participants to offer more competitive quotes and larger sizes as the physical proximity reduces their operational risk inherent in posting liquidity on the exchange. The reduced spreads and added liquidity available in the marketplace benefits all trading participants.

4. **Does the latency benefit for firms using co-location services create any issues for the fairness and efficiency of markets?**
   Co-location services provides benefits to all trading participants, provided that the services are transparent and fair. The users of these services adopt very different trading strategies from those that are in less latency sensitive strategies and are therefore able to co-exist and in many cases interact with each other.

5. **In your view, do co-location services create an issue with the MiFID obligations on trading platforms to provide for fair access?**

   The provision of co-location services provides issues with MIFID obligations only insofar exchanges that do not offer co-location services at all or not in a transparent and fair manner. We see the provision of co-location services as an essential component of fair access to the marketplace.

6. **Do you see a need for regulatory action regarding any participants involved in co-location, i.e. firms using this service, markets providing the service and IT providers? Please elaborate.**

   There is a good case to be made for additional regulation in this area as some exchanges do not provide this service in a transparent and fair manner or at a reasonable price point and therefore advantage either larger trading participants or trading participants that happen to be located near the exchange. In order to maintain reasonable fees and to prevent vertically integrated firms from unilaterally dictating prices, and promote fair competition, IMC believes that the exchanges should allow multiple connectivity providers access to their co-location sites.

IV. <u>Fee Structure</u>

1. **Please describe the key developments in fee structures used by trading platforms in Europe.**

   The US experience as well as recent European experience has shown that the most effective way for exchanges to attract order book depth as well as narrow spreads is by incentivizing liquidity providers to post liquidity. Under best execution rules order flow will be directed to a venue if the venue displays the best price available at that point in time. The maker/taker model has provided incentives for liquidity providers to post quotes onto platforms and has therefore enabled the exchanges to compete for order flow. This has resulted in a narrower spread and more liquidity available in the marketplace than was available under the various models that existed prior to this.

2. **What are the benefits of any fee structures that you are aware of?**

- The maker/taker fee structure provides the benefit of incentivizing liquidity providers, resulting in more liquidity at narrower spreads than otherwise would be available.
- The maker/taker fee structure is also transparent and fair to all, as opposed to many of the older models that prevailed prior to competition between exchanges. The incentives received by market makers used to be only available to member firms, where in the maker/taker model these incentives are available to all.
- The maker/taker fee structure has also proven to be effective at stopping undesirable practices such as payment for order flow. The advent of the maker/taker fee structure combined with decimalization in the US has vastly reduced the economics in the payment for order flow business

3. **Are there any downsides to current fee structures and the maker/taker fee structure in particular? If yes, please describe them.**

   There are no downsides to the maker/taker fee model that we are aware of

4. **What are the impacts of current fee structures on trading platforms, participants, their trading strategies and the wider market and its efficiency?**

   The maker/taker fee structure allows for exchanges to compete with each other effectively by recognizing the importance of liquidity providers in the marketplace. It ensures the posting of more competitive quotes at larger sizes than what would be available with other fee structures.

5. **How important is the fee structure of a trading platform in determining whether to connect or not to it for trading. Please elaborate.**

   The liquidity of a platform will always be a primary consideration in whether or not it makes sense to connect to a venue. The fee structure is, however important in that venue's ability to attract order flow and be successful. It is clear from the US and European experience that the maker/taker fee structure continues to be the most successful model at attracting liquidity.

6. **Do you consider that the fee structures of trading platforms should be made public to all market participants? Please provide a rationale for your answer.**

   We firmly believe in transparency to all market participants. This would certainly include fee structures. IMC also believes in a fee structure that is competitive to all market participants, not just the largest ones.

7. **Is there a role for regulators to play in the fee structures? If yes, please describe it.**
   We believe that market forces should determine both the structure as well as the level of fees, as long as they are transparent to the marketplace and available to all market participants.

V. <u>Tick Size</u>

1. **In your view, what has been the impact of smaller tick sizes for equities in Europe on the bid-ask spreads, liquidity, market depth and volatility of these markets? Are there any spill-over effects on derivatives markets?**
   The smaller tick sizes have clearly resulted in narrower bid-ask spreads and depth to the market. Given recent market conditions it would be premature to make an accurate assessment on the effects on liquidity and volatility.

As the derivative markets have not seen the same competitive dynamics as we have seen in the equity markets, there has been less focus on the reduction of tick sizes in these asset classes. If competition between exchanges increases, which we believe will be very difficult without regulatory intervention, there would be a need for harmonization of tick sizes.

2. **What are the benefits/downsides of smaller tick size regimes for shares in Europe?**

   Smaller tick sizes can facilitate tighter bid-ask spreads, however at this juncture it appears that an equilibrium has been reached in the equity markets and there would be no good reason to reduce tick sizes further at this point. Reducing tick sizes can have negative ramifications on execution costs if fees are charged on a per trade basis and trade sizes are reduced.

3. **Is there a need for greater harmonisation of tick size regimes across Europe? Please elaborate.**

   IMC believes that tick size harmonization is essential and applauds the work that FESE has done in this regard. We do not see any pressing need for further action in this respect, although possible moves towards derivative markets competition may reopen this debate.

4. **Is there a role for regulators to play in the standardisation of tick size regimes or should this be left to market forces?**

   Market forces in Europe have made great progress in standardizing tick sizes. However, the regulators should monitor to make sure that standards are maintained and met, as well that the end investor benefits from the development of standardize tick sizes.

5. **Have organised markets developed an appropriate approach to tick sizes?**

   Yes.

6. **Should regulators monitor compliance with the self-regulatory initiative of the MTFs and FESE? If this initiative fails, do you see a need for regulators to intervene?**

   Yes, regulators should monitor compliance and how it evolves. Please see #4.

7. **What principles should determine optimal tick sizes?**

VI. <u>Indications of Interest (IOIs)</u>

1. Please provide further information on how IOIs are currently used in European markets by investment firms, MTFs and RMs?

2. Which are the key benefits/downsides of such IOIs? Please provide evidence to support your views.

The main downside of IOIs are that they reduce transparency and are only provided to a subsection of market participants. IMC is a big believer in open and transparent markets that are fair and equitable to all market participants.
We also believe in the Auto-ex model where prices are at all times tradeable rather than an indication where the market maker decides after an order is received. There is no doubt that this a license for market abuse. We are therefore firm opponents of some of the warrant trading models that exchanges have allowed to evolve.

IMC is also firmly opposed to the use of flash orders for the same reasons as the one mentioned above.

3. Do you consider that MiFID should be amended to clarify that actionable IOIs should be subject to pre-trade transparency requirements?

We believe that actionable IOIs should be subject to the same pre-trade transparency requirements as any other firm order.

4. Do you see circumstances where it would be appropriate for IOIs to be provided to a selected group of market participants? Please provide evidence/examples to support your views.

We fail to see how the market would be better served by sharing important information with only a selected group of market participants