European Principal
Traders Association

October 3, 2011

European Securities and Market Authority
103 Rue de Grenelle
75007 Paris
France

Dear Sirs,

The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to comment on the ESMA Consultation Paper "*Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities*" (the Consultation Paper).

FIA EPTA members engage in manual, automated and hybrid methods of trading on exchanges located around the world and are active in cash and derivatives in a variety of asset classes, such as equities, foreign exchange, commodities, and fixed income. In their capacity as principal traders, these firms only trade for their own accounts and represent a substantial part of the traded volume on European regulated markets and MTFs.

The members of FIA EPTA have a vested interest in well-regulated markets and strongly support regulatory initiatives to protect the stability and integrity of the markets. We support well-defined and clear regulations to detect, deter and enforce against fraudulent and manipulative behaviour. FIA EPTA members especially support the deployment of robust risk management controls by all market participants to promote fair and orderly markets. Therefore our members welcome this effort by ESMA to provide clarity on the obligations for trading platforms, investment firms, and direct market access and sponsored access under the existing legal framework. We believe ESMA has touched upon some very important issues with regard to automated trading and we are generally supportive of the guidelines ESMA has drafted in addressing these issues. Risk management best practices, however, are continually evolving due to the ongoing efforts made by many sectors of the marketplace, in light of changing circumstances and technological improvements. Regulators should be hesitant to "freeze" the state of the art by imposing a particular set of risk management controls on market participants – to do so may prevent the application of more effective risk management tools as technology becomes increasingly sophisticated.

Members of the FIA EPTA collaborated on the attached response, which comments on the guidelines in the consultation paper and responds to the questions posed therein.

We would be happy to provide additional information as needed.

Respectfully submitted,

Remco Lenterman
Chairman
FIA European Principal Traders Association

FIA European Principal Traders Association
Response to the ESMA Consultation Paper:

Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities

The comments presented in this response represent the views of the FIA European Principal Traders Association.[1] FIA EPTA members engage in manual, automated and hybrid methods of trading on exchanges located around the world and are active in cash and derivatives in a variety of asset classes, such as equities, foreign exchange, commodities, and fixed income. In their capacity as principal traders, these firms trade for their own accounts and do not handle customer funds.

All principal traders have a vested interest in well-functioning markets with effective risk controls, clear error trade policies that focus on trade certainty, and a strong regulatory framework. Among the principles on which FIA EPTA is founded, is that our members believe in having risk controls in place to promote safe and secure markets.[2] We ask that regulators recognize that trading firms are proponents of robust pre- and post-trade risk policies and procedures. Moreover, we believe there is already a high degree of compliance among such firms with the standards set out in the guidelines because the greater control firms have over the orders they place, the less risk exposure for the firm's capital and the better prices and greater sizes they can offer. This increases their likelihood of sustainability and improves the quality and safety of the market.

General comments on the Consultation Paper

Over the last decade technological advancements have had an enormous impact on financial markets in general and the way financial instruments are traded in particular. Numerous studies have provided evidence of the benefits markets and market participants now enjoy because of technology.[3] But these technological changes call for new approaches to regulation.

---

[1] The FIA European Principal Traders Association was founded in June 2011 and is comprised of 20 principal trading firms. The mission of the FIA EPTA is to support transparent, robust and safe markets with a level playing field for all market participants. The group will work to define common positions on public policy issues, improve the public's understanding of the constructive role played by principal trading groups in the exchange-traded markets and promote cost-effective, equal and transparent access to European markets.

[2] http://www.futuresindustry.org/epta/fia-epta-principles.asp.

[3] The FIA EPTA web sites contain an extensive list of academic papers on high-frequency and algorithmic trading and other market structures issues: http://www.futuresindustry.org/epta/academic-research.asp.

FIA EPTA believes that the ESMA consultation paper appropriately supports the issuance of relevant guidelines for trading platforms, investment firms and competent authorities. The guidelines will offer more clarity and consistency on the requirements with which trading platforms and investment firms have to comply, which is in the interest of all market participants. We do, however, have some comments on the guidelines and some suggestions for improvement, which you will find in our answers to the individual questions. We would nonetheless like to start with some general remarks on the Consultation Paper.

Proportional approach

FIA EPTA strongly supports the guidelines proposed by ESMA, but we believe in some areas the guidelines would benefit from an approach allowing for a certain amount of proportionality or flexibility in applying the requirements, depending on the nature, scale and complexity of firms' trading activities. One-size-fits-all guidelines that impose compliance requirements that are unnecessary or inappropriate for all firms would constitute a significant barrier to entry for new participants in electronic markets. In particular, we suggest that any regulatory requirements for professional trading firms without customers be appropriate and limited. Unnecessarily high regulatory burdens would reduce competition, contrary to the objectives of MiFID, and reduce the benefits that competition can bring to financial markets.

In general, many of the guidelines proposed by ESMA would require policies and procedures "to ensure" a particular outcome. FIA EPTA is concerned that "ensuring" compliance in the strict sense of this word is an unrealistic and unattainable standard. Instead, FIA EPTA believes that policies and procedures by trading platforms or investment firms should be *reasonably designed* to *establish* compliance. As an example, FIA EPTA supports the requirement that every investment firm should have processes in place to approve changes and verify internal testing before a new trading system can be enabled in production. However, it is an unattainable requirement to *ensure* absolutely how an automated system (or indeed human actors) will perform in unpredicted and unpredictable market conditions.

With regard to order entry, FIA EPTA members agree that firms should build into their automated systems checks that prevent the entry of orders that exceed pre-set credit or capital thresholds for clients, or that breach risk limits for individual traders, trading desks or the firm as a whole. But some firms operate risk systems per trading desk, others per individual trader, and the requirements for limits should entail the flexibility to accommodate different set-ups. Likewise, such limits should be able to be adjusted to take into account the likelihood of execution and also vary based on sector, security or other limiting factors. We strongly believe the guidelines should allow for flexibility in how firms tailor such limits to their business models.

We also believe that the guidelines as currently drafted with respect to business continuity will be disproportionate for many principal trading firms. In particular, it is not a business requirement for firms *without customers* to be able to operate their electronic trading system from a back-up site with full functionality.

Market forces

All principal traders have a vested interest in well-functioning markets with effective risk controls, supported by a well-designed regulatory framework. We believe that market forces are strong drivers for robust risk controls. RMs, MTFs and investment firms have strong commercial incentives to have appropriate risk management controls and that, notwithstanding the considerable growth in volumes and increased speed of trading, the capabilities and execution of automated risk management systems by investment firms and RMs and MTFs are generally satisfactory.

FIA EPTA strongly believes market forces will, for example, lead to models for regulating traffic in a commercially flexible manner. Though many exchanges already have order-to-trade ratios in place, we note that the need for such controls is often linked to the technological sophistication of the platform. Many of the MTFs in Europe attempting to compete with the incumbent exchanges tend to have no need for order-to-trade ratios as their technology tends to be more advanced. Enforcing a guideline on order-to-trade ratios would be distinctly anti-competitive, as it would virtually kill any new initiative to start a new exchange (as a new trading platform will always have a high order-to-trade ratio during its start-up phase) and at the same time discourage incumbent exchanges from investing in their technology.

In the same way it will be the technological capabilities of a firm that will regulate the amount of messages it can send. And we would like to reiterate that users of trading platforms should not have any incentive to overload trading platforms because that would lead to queuing, which would lead to trading losses.

FIA EPTA believes it is most efficient if exchanges and platforms act as the "gatekeepers", restricting orders according to their technological capabilities, and that users adapt their systems dynamically.

Manipulative behaviours

Guidelines 5 and 6 deal with organizational requirements for trading platforms and investment firms in preventing market abuse and "in particular market manipulation". However, regulation has so far evaded a clear definition of market manipulation[4]. ESMA references within the explanatory note to Guideline 5 current regulatory guidance that provides definitional scope of the term, and goes further by illustrating examples of what might constitute market manipulation. We applaud this approach but would suggest that ESMA go a step further than explanatory note 38 by providing better examples of the specific behaviours that it wishes the scope of market manipulation to cover.

This is particularly prudent given that there has been significant confusion in the public discourse and lack of clarity around what constitutes market abuse, which only inflates the misconception in some quarters that the advancement of automated trading technologies has somehow resulted in a decline in market integrity. The marketplace as a whole would benefit from a more illustrative definition of market manipulation and examples of what constitutes the behaviour intended to be prohibited.

Further clarity would also allow for better monitoring and surveillance capabilities, and therefore would improve the ability of RMs and MTFs to identify manipulative behaviour.

[4] Manipulation is being addressed currently by the US regulators as part of the Dodd-Frank legislation as are questions related to defining disruptive market practices. FIA has filed letters discussing both manipulation and disruptive trading prices, which although comments focus on implementation of the US legal regime, can be instructive to the discussion of these topics in the EU: http://www.futuresindustry.org/downloads/CFTC_Manipulation_FIA_ISDA_SIFMA_122810.pdf
http://www.futuresindustry.org/downloads/CFTC_Antidisruptive_122310b.pdf
http://www.futuresindustry.org/downloads/AntidisruptivePracticesAuthorityProposedInterpretiveOrder051711.pdf

Automated vs. manual trading

Some market participants fear and misunderstand fast-moving technology. The technological revolution in trading methods has confused some traditional investors - both retail and professional – and has led some of them to allege that these new trading technologies are a market integrity issue. FIA EPTA believes it would be overly simplistic to blame any perceived deterioration in market integrity on the technological advancements in trading (in fact, empirical measures of market quality show improvements in liquidity, transparency, price discovery and micro-volatility in automated markets). Manipulative practices, unfortunately, are not uniquely employed by any particular type of market participant; rather, they have been employed by participants for many years, whether by means of automated trading techniques or not.

Thus, FIA EPTA believes that the focus of ESMA in preventing manipulative behaviour should be primarily on the *strategies* employed by investment firms, rather than on the *technologies* that are used. On this basis, the guidelines that ESMA has drafted for dealing with market manipulation should be equally applicable (and can in the current wording be equally applied) to investment firms that deal on their own account (or execute client orders) without using sophisticated technology.

In addition, we would urge ESMA to ensure that RMs' and MTFs' operating guidelines be applicable to all of their member participants, not just automated trading members.

DMA/SA

FIA EPTA believes that appropriate supervision of all market access is an important tool in limiting risk to the financial markets. We do not believe that ESMA should establish different guidelines depending on the type of market access. Because all market access – whether as principal or agent and whether DMA or SA – creates risks, the same principles should apply to all market access.

Members of FIA EPTA believe that, in many cases, risk controls with regard to DMA or SA should reside at the level of RMs and MTFs. Pre-trade risk controls, such as those set forth in paragraph 2 of Guideline 4 and referenced in paragraph 2 of Guideline 8, can be put in place at the investment firm or trading platform level. However, requiring RMs and MTFs to provide investment firms with such basic risk management tools, would provide a more uniform set of risk management controls and would eliminate the advantage that an investment firm may try to provide its clients through less responsible, but also less latent, risk management controls. Such uniform RM/MTF-based risk management controls should apply to all persons with market access, whether trading as direct members or via DMA or SA. Nevertheless, setting the *parameters* of pre-trade controls provided by an RM/MTF should be the responsibility of the investment firm providing access to its client or of such client's clearing firm.

Cost-benefit analysis

As noted, ESMA is required to analyze the potential costs and benefits of any guidelines and recommendations. In furtherance of this requirement, ESMA published its assessment in Annex III.

As discussed in further detail in our response, FIA EPTA supports ESMA's proposed guidelines for trading platforms and investment firms. As markets change, such as by market participants' greater dependence on technology, it is important that systems and controls, and regulators' expectations regarding such systems and controls, change too. In Annex III, ESMA reviews the impact of algorithmic trading on market quality, while acknowledging that an overall assessment of the balance of costs and benefits or recent changes in market structure largely remains to be explored.

To the extent that ESMA chooses to review the impact of algorithmic trading, including high-frequency trading, FIA EPTA request that ESMA make it clear that such a review is a separate area of inquiry from the cost-benefit impact of risk control guidelines, in order to avoid conflating the two topics.

FIA EPTA notes, with concern, that many of the views contained in ESMA's consultation paper regarding algorithmic trading reveal a skepticism that is not supported by clear evidence. For example, ESMA states that "*according to academic literature, the effects of algorithmic trading are mixed*". The academic literature, however, is quite supportive of algorithmic trading, finding evidence of tighter spreads and increased liquidity. FIA EPTA believes that ESMA's discussion should take a more balanced approach to considering the impact of algorithmic trading on markets.[5]

ESMA's draft guidelines are designed to control the risks that arise from trading in a highly automated environment.[6] The cost-benefit assessment appropriately notes that *"[t]he development of algorithmic trading strategies, including HFT, has brought considerable change in the order processing chain at trading venues […] and new risks have emerged as a result*." However, ESMA concludes by stating that *"[d]evelopments observed in the European marketplace linked to algorithmic trading and new forms of access to trading platforms by persons who are not members of those platforms triggers various types of market failures which require adapting applicable regulatory frameworks*". FIA EPTA believes the consultation paper does not provide clear evidence of such market failures that would support such a conclusion.

In particular, FIA EPTA does not believe ESMA has provided any support for its conclusion that increases in message traffic increases uncertainty and reduces financial stability.[7] In addition, FIA EPTA believes ESMA should acknowledge that technology can improve competent authorities' ability to promote market integrity. FIA EPTA strongly supports providing regulators with the necessary tools to conduct surveillance and detect market abuse and believes technology can be an important tool for market authorities. Electronic markets facilitate the automatic recording of messages and make it possible to create a complete audit trail. By contrast, when trading is done by voice communication, there is often an imperfect audit trail, making it impossible to detect market abuse. For this reason, FIA EPTA does not believe ESMA can draw the conclusion it has that *"[i]t is becoming harder for competent authorities to promote market integrity, including detecting market abuse*."[8]

Response to the individual questions

---

[5] Another example that supports our concerns is found in paragraph 9 of Annex III, which states: *". . . if information asymmetries between market participants increase as a result of AT/HFT, they may lead to a decrease in the participation of some types of investors in the markets (adverse selection), resulting in a negative effect on trading volumes*." However, there is no evidence that information asymmetries increase as a result of AT/HFT, so FIA EPTA does not believe such a statement is appropriate in a Review of Academic Evidence.

[6] Consultation paper, Background, paragraph 21.

[7] Annex III, paragraph 10.

[8] Annex III, paragraph 12.

Q1: Do you agree with ESMA that it is appropriate to introduce guidelines already before the review of MiFID covering organisational arrangements for trading platforms and investment firms in relation to highly automated trading, including the provision of DMA/SA?

FIA EPTA agrees that this is appropriate but notes that rules pertaining to all market participants are generally preferable to rules that single out particular classes of market participants or trading strategies.

Q2: Do you think that the draft guidelines adequately capture all the relevant points relating to the operation of trading platforms' electronic trading systems?

FIA EPTA agrees that the guidelines presented capture the majority of the relevant points relating to the effective and efficient management of trading platforms' electronic systems. However, FIA EPTA would like to see the guidelines go further toward establishing a framework for a clear and consistent application of rules across trading platforms and highlighting the necessity for a uniform approach to the implementation of controls across platforms.

For example, the manner in which platforms perform technological testing varies greatly across the industry. The multiple platforms have diverse mechanisms to perform system stress tests and establish maximum IT capacity. The requirements for client conformance testing (and the systems available to clients to conduct this testing) vary just as greatly from platform to platform.

FIA EPTA believes ESMA should give particular scrutiny to the manner by which platforms establish their maximum capacity limits. The fact-finding cited by ESMA indicates platforms assess performance capacity using a multiple of 20 times the order flow derived from the busiest trading days. However, there is no consistent approach to measuring this order flow over the busiest days. Furthermore, this process fails to identify those challenges to system performance created by high data rates over short timeframes. A better approach would be a mechanism to assess peak intraday load for capacity planning.

In addition, FIA EPTA regards the proposed process "*to ensure that capacity limits are not breached by controlling the volume of messages that members / participants or users can send*" (in explanatory note 14) as sub-optimal. Although specific firms may be restricted by a pre-defined messaging policy, it is not clear how all platforms can even-handedly apply a data rate restriction in times of market stress. A message throttle approach limits investment firms' ability to control their risk by deleting or adjusting orders at a time when both matching and market-data processes have approached capacity. Such a scenario challenges price discovery and therefore market integrity. Platforms should be obliged to call a full halt to trading in instances where their electronic systems fail to handle the data rates expressed by the market.

FIA EPTA also recommends that all trading platforms should provide cost-effective, realistic conformance / user-acceptance testing environments, allowing participants to meaningfully test systems at the exchange in anticipation of a safe and controlled electronic trading system release process.

Q3: Are there areas where it would be helpful to have more detail on the organisational requirements applying to trading platforms' electronic trading systems?

Please refer to FIA EPTA's response to Question 2.

Q4: Do you have additional comments on the draft guidelines on organisational requirements for trading platforms' electronic trading systems?

Please refer to FIA EPTA's response to Question 2.

Q5: Do you think that the draft guidelines adequately capture all the relevant points related to the operation of trading algorithms?

FIA EPTA believes that any new guidelines recommended for investment firms should leave room to accommodate firms' different business models and circumstances. The sections of the MiFID directives referenced by these guidelines require that a firm is organised in such a way that its policies, systems, and procedures will be suitable for it to manage its risks and fulfil other regulatory obligations, taking into account its individual circumstances. These circumstances include the nature, scale and complexity of its business and its risk tolerance. "One-size-fits-all" guidelines that impose unnecessarily burdensome compliance requirements on all firms would constitute a significant barrier to entry and competition for participants in electronic markets, and would thereby harm market quality.

In particular, FIA EPTA suggests tailoring regulatory requirements for principal trading firms to reflect such firms' limited scope – principal trading firms trade their own capital exclusively, do not have clients' money at risk, and therefore have a different risk profile than other market participants.

FIA EPTA agrees with the "general guideline" directing firms to take into account technological advancements.

Capacity
However, FIA EPTA urges ESMA to avoid overly intrusive guidelines regarding capacity. We do not believe that the increase in message traffic constitutes a systemic risk for the markets or poses costs disproportionate to its benefits. Commercial market forces have led exchanges and other platforms to manage increasing message traffic for many years, by developing tools and systems to deal with high message volumes. These include highly scalable infrastructures, permanent or selectively applied message volume throttles, and investigations of abnormally high message traffic. Subject to our comments in Question 4, we believe the application of these methods by the exchanges has been more or less effective. We do, however, urge trading platforms to continue to develop their ability to define system capacity and plan for extraordinary circumstances, as set out in our earlier response.

In this context, we view the text "*through a 'normal activity / maximum IT capacity' ratio*" (in guideline 2) as unclear and adding little value. We suggest deleting it rather than attempting to clarify it.

Business Continuity
FIA EPTA regards the guidelines on business continuity as disproportionate for many principal trading firms and urges ESMA to avoid prescriptive standards on business continuity where a firm's business context does not require it. In particular, firms without customers do not necessarily need to be able to operate their electronic trading systems with full functionality from a back-up site. We would refer

ESMA to the FIA Principal Trader's Group's "Recommendations for Risk Controls for Trading Firms" paper, which notes pragmatic and effective alternatives to operating a fully redundant trading system at a back-up site. Specifically, the FIA PTG analysis indicates that the requirements for firms should be non-prescriptive, but that firms should consider the implications of stand-by facilities and alternative platforms in the context of their business models and potential impact on the financial markets. The paper recommends:

- Firms should consider the necessity of a comprehensive disaster response plan in the context of their business.
- Firms should consider the utility of stand-by failover for production infrastructure.
- Staff must have training, experience and tools that enable them to monitor and control the trading systems and troubleshoot and respond to operational issues in a timely and appropriate manner.
- Firms should recognize availability of alternative trading platforms and documented procedures for alternative trade execution methods
- Firms should have logs documenting the execution of trades *via* alternative methods

Testing

FIA EPTA believe that firms should have processes in place to approve changes and verify internal testing before a new trading system can be enabled in production. Such processes should establish that the compliance and risk management controls embedded in the system or algorithm work as intended and that the interfaces with trading platforms are tested prior to live trading. However, it is impossible to ensure with certainty how an automated system (or indeed human actors) would ultimately behave in stressed market conditions. Therefore, firms must be able to reassess their deployment of electronic trading systems when market conditions precipitate unexpected or undesirable behaviour. The risks arising during stressed market conditions are best mitigated through a combination of best practices, such as those defined in the FIA PTG's "Recommendations for Risk Controls for Trading Firms" paper, and a market structure that includes well-designed safeguards like circuit breakers.

Records

FIA EPTA believes the guidelines as currently drafted result in a broad and overly ambiguous requirement. FIA EPTA believes that trading firms should have written records of the procedures described. However, some of these procedures, particularly software and algorithm testing, generate a large volume of intermediate results that are not relevant to or representative of the end product. It would be disproportionately costly to store these and would add no value. We suggest that this requirement be narrowed to focus on records of trading, compliance and risk management controls, documentation of the processes in place, and evidence that processes are followed.

FIA EPTA also strongly disagrees with the suggestion (in explanatory note 17) that "*adequate record is kept that explains the trading strategy or strategies each algorithm is deployed to execute*". Explanation of a strategy is unlikely to capture the key risks associated with the deployment of an electronic system. In addition, electronic systems may be adapted or re-parameterised frequently to optimise processes interacting with the live public markets, rendering this requirement both unhelpful and unnecessarily burdensome. There should be no barrier to electronic system optimisation; therefore a documentation / sign-off process could significantly increase risk. Instead, the ESMA guidelines should remain focused on defining best practices and appropriate behaviours without promoting overly onerous requirements. In this case, ESMA should indeed seek a framework for safe and controlled systems rollout, systems monitoring and effective risk control through appropriate pre-trade and post-trade analyses without recourse to the collation of detail.

FIA EPTA believes there is no benefit to be gained from the restriction (in explanatory note 28) that "*the algorithm cannot be used for other trading strategies than it is intended to be used and signed off for*". If the guidelines focus on best practice, in particular with regard to internal controls, controlled release and risk control frameworks appropriate for the electronic systems deployed by firms, then the detailed requirement to restrict application is unnecessary. FIA EPTA does agree the guidelines correctly stress that "*investment firms need to be cautious when putting an algorithm (and any update to an algorithm) into production,*" which would be covered under a best practices regime.

Incident reporting
FIA EPTA notes that the guideline on incident reporting falls outside the scope of the referenced sections of MiFID. Several trading platforms' rulebooks oblige members to inform the trading platforms of such incidents. FIA EPTA believes that this is a sufficient notification requirement, that the platforms are best equipped to react to such notifications, and that adding a requirement to additionally notify regulators would increase risks by consuming resources that firms would otherwise be able to direct to resolving the incident(s) in question.

Q6: Are there areas where it would be helpful to have more detail in the guidelines applying to the organisational requirements for investment firms' electronic trading systems?

Please refer to FIA EPTA's response to Question 5.

Q7: Do you have additional comments on the draft guidelines relating to organisational requirements for investment firms' electronic trading systems?

Please refer to FIA EPTA's response to Question 5.

Q8: Do the draft guidelines on organizational requirements for trading platforms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

FIA EPTA believes trading platforms must use their technical capabilities to promote fair and orderly markets to the greatest extent possible. In the same way that highly automated trading firms must continually invest in technology, both to capture opportunities as well as to manage risks, exchanges and platforms must also ensure their technological systems are state-of-the-art. Wherever possible, undesirable market conduct that can easily be prevented should be technically restricted through the trading platform's systems.

The primary business and function of exchanges is matching trades and regulating their markets to ensure that they operate consistently and with minimal systemic risk. The default or failure of a client of a clearing member has no immediate risk consequences for the clearinghouse unless it causes losses that lead to the default or failure of the clearing member. However, exchanges nonetheless implement controls to avoid such events in order to protect the overall integrity of the marketplace. Advances in telecommunications, falling hardware costs and efficient APIs have improved execution venues' ability to monitor order entry flow and to intervene when messages threaten the integrity of the market. The systems of exchanges and platforms should be technologically advanced enough to detect and deter abuses by market participants, for example (but not limited to) detecting and preventing accidental cross trades.

Recommended Implementation

- To reduce the inevitable errors that may occur with manual data entry, exchanges should work towards providing a standard communication protocol that would allow firms to automate settings and risk parameter updates. This would also enable clearing firm risk management to disable clients from multiple exchanges simultaneously and efficiently. An API based on an agreed standard protocol such as FIX would be the preferred method for entering and updating limits.
- Unless otherwise indicated, risk control systems at the exchange level should provide clearing firms with the ability to define risk controls per product. All limits should be set by positive permissioning. The auto-default should be set to zero (i.e. clearing firm will set limits only for the products they authorize the trading firm to trade).
- A good example of a useful risk control implementation is the self-trade prevention modifiers implemented by NYSE Arca and BATS US[9].

For a detailed description of pre-trade execution risk controls, we refer ESMA further to the FIA Market Access Risk Management Recommendations.[10]

Q9: Are there any areas of the draft guidelines on organizational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

FIA EPTA requests more detail on the guidelines governing message traffic, a regulation which we strongly believe should be left to commercial forces (as discussed in Questions 2 and 5). Trading platforms are in the best position to determine what means, if any, of regulating order to trade ratios are best suited for their markets. Many exchanges have technical or price-based means in place to limit order-to-trade ratios based on their infrastructure capacity, while many of the MTFs in Europe attempting to compete with the incumbent exchanges tend to have no such limits, as their technology is more advanced. Mandating a fixed order-to-trade ratio would therefore be distinctly anti-competitive, as it would virtually kill any initiative to start a new exchange.

We do agree that exchanges should consider policies to discourage market participants from creating excessive, low-quality messaging, which can negatively impact both exchange and customer bandwidth and systems. A good example of a creative, non-prescriptive, and effective approach to curtailing superfluous bandwidth usage while maintaining a deterministic order life-cycle is IntercontinentalExchange's "Weighted Volume Ratio" ("WVR") messaging rule.

ICE's WVR accomplishes all of this by defining a ratio between the number of messages (new orders, cancels, modifies, etc.) an electronic trading system ("ETS") sends and the total volume of orders the ETS executes. If an ETS exceeds the posted WVR limits, the ETS' owner is fined. If this behaviour continues, the ETS' owner faces possible suspension of direct market access privileges.

The truly creative part of this solution is that ICE assigns a weighting scale based on the message's price level relative to the current best bid and offer. If the order in question has a price equal to the best bid

[9] NYSE Arca Equities Self-Trade Prevention Modifiers http://www.nyse.com/pdfs/STP_Modifier.pdf
[10] FIA Market Access Risk Management Recommendations April 2010: http://www.futuresindustry.org/downloads/Market_Access-6.pdf

or offer, the message does not count towards the WVR. If it is one tick away from the best bid or offer, the message has a weighting multiplier of 0.5 for orders on outright futures and 0.25 for spreads. This multiplier continues to increase until the order in question is more than five ticks away from the best bid or offer. At that point, the message has a weighting multiplier of 3.0 for outright futures and 2.0 for spreads. By imposing the WVR, ICE has simultaneously incentivized firms to submit orders that are likely to be filled while penalizing firms that submit orders that are unlikely to be filled.

Q10: Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

Trade cancellation procedures
FIA EPTA urges exchanges to publish clear, objective and transparent policies governing the procedures for cancelling, amending or otherwise correcting transactions. Currently, most platforms enjoy a high degree of discretion when deciding on trade cancellations. Often the same situation will be treated differently by various platforms. The uncertainty that arises may lead to even less liquidity in times of distressed markets when liquidity providers retreat from the market to avoid becoming subjected to arbitrary decision-making. According to the SEC-CFTC Report following the 2010 May 6th flash crash, "FINRA and exchanges busted trades that were 60% away from the reference price, using a non-transparent process".[11] In the aftermath of these events, the SEC, together with US exchanges and FINRA, has taken steps to enact rules that provide greater certainty as to which trades will be broken in case of aberrant price movements.

FIA EPTA strongly believes exchanges should publish and follow clear, objective and transparent standards for trade cancellations. We call upon ESMA to ensure that no trades can be subjected to discretionary cancellation decisions by exchanges or platforms, and that all grounds for cancellation be explicitly and objectively described in the rulebooks of the relevant exchange or platform.

Circuit breakers and limit up/limit down
FIA EPTA believes exchanges should introduce measures reasonably designed to reduce market distress that is the result of erroneous trading or extreme nervousness. The US markets already tackle this through mechanisms such as circuit breakers[12]. Where there is extreme volatility in a stock, a circuit breaker provides for a pause in trading that allows market participants to evaluate the trading that has occurred, correct any erroneous "fat finger" orders, and to allow a more transparent, organized opportunity to offset the order imbalances that may have caused the volatility.

While pause rules represent a critical interim step in addressing instances of extreme market or sector-wide volatility, operating alone they have a number of drawbacks. Specifically, their five-minute duration completely restricts trading in a security even if contra-side liquidity has returned to the market. This can be particularly problematic in situations where a single erroneous trade triggers the pause. Similarly, pauses do not fully address the impact of an erroneous trade because they do not prevent the execution and reporting of the initial trade that triggers the pause. This allows potential trade prices to be reported considerably below or above the price that triggered the pause.

---

[11] Recommendations regarding regulatory responses to the market events of May 6, 2010. Summary of the joint CFTC-SEC advisory Committee on emerging Regulatory Issues.
[12] We use "circuit breaker" to describe the mechanism that triggers a pause in execution.

Another approach would be the introduction of “limit up / limit-down” rules along the lines of those used by, for example, the CME. Such procedures would require that the market enter a “limit state” if a financial instrument moves a set percentage over a rolling five-minute period. During the “limit state,” executions could not take place outside of a specified price band. Unlike a pause, however, the market could naturally exit the “limit state” at any time that contra-side liquidity appears at a price above the limit price. The “limit up / limit down” price bands would be set based on a “reference price” that would reflect VWAP or other similar average price calculations over the preceding rolling five minutes (or a shorter period in the first five minutes after the open).

In FIA EPTA’s view, a combination of circuit breakers and limit up / limit down rules is the optimal solution to reduce market distress after an error or in times of panic. If a financial instrument were to first become subject to a limit up / limit down (as the case may be) and only trigger a pause when contra-side liquidity did not appear during a relatively short timeframe, it would address many of the adverse impacts of circuit breakers used alone.

Q11: Do the draft guidelines on organizational requirements for investment firms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

FIA EPTA supports the draft guidelines on order entry controls to be applied to investment firms. Principal trading firms are proponents of robust pre- and post-trade risk policies and procedures. The greater control firms have over the orders they offer on the market, the less risk exposure for the firm’s capital and the better prices and greater sizes they can offer, which increases their likelihood of sustainability and improves the safety and quality of the market. In FIA EPTA’s view, there is already a high degree of compliance among such firms with the standards set out in the guidelines and sufficient market forces that will drive participants to comply even in the absence of regulation, but we nevertheless support the guidelines in this area.

However, as discussed in previous sections, FIA EPTA supports flexible and proportional requirements that allow firms reasonable discretion to tailor controls to the business model of the relevant firm. In the context of pre-order controls, for example, trading participants should be permitted to adjust controls to take into account the likelihood of execution and also fine-tune risk thresholds based on sector, security or other limiting factors.

FIA EPTA also believes exchanges and other platforms share the compliance burden in mitigating the risks related to electronic trading.

Regarding the scope of application, FIA EPTA believes that appropriate supervision of all market access is an important tool in limiting risk to the financial markets. We do not believe that ESMA should establish different guidelines depending on the type of market access. Because all market access – whether as principal or agent and whether DMA or SA – creates risks, the same principles should apply to all market access. For this reason, FIA EPTA does not believe the guidelines to promote fair and orderly trading by investment firms should be different from the guidelines to promote fair and orderly trading by clients of those investment firms.

The issues highlighted by ESMA comprise, in the opinion of FIA EPTA, a comprehensive list of relevant topics, with further input below:

Erroneous Order Entry (Pre-Trade Risk Controls)
The ability to quickly modify orders to reflect updated information in revised prices is integral to the business model of trading firms in the highly automated environment. Likewise, investment firms' electronic trading systems will prevent erroneous orders by rejecting orders that exceed appropriate price or size parameters, or indicate duplicative orders. Pre-trade controls should also be able to prevent entry of orders unless they comply with pre-trade regulatory requirements (for example, relevant short-sale restrictions). Finally, systems should also prevent orders for persons restricted from trading certain securities and restrict access to those persons/accounts pre-approved and authorized by the firm.

Throttling
With respect to limits on messaging (or "throttling" orders), FIA EPTA strongly believes market forces will lead to models for regulating traffic in a commercially flexible manner that does not unduly sacrifice the benefits to all market participants of firms being able to manage their orders in the market. In FIA EPTA's view, exchanges and platforms are in the best position to enforce this type of control based on infrastructure capacity, though we note that any need for such controls would typically be linked to the technological sophistication of the platform (in the same way that the technology of each firm will regulate the amount of messages it can send). Platforms with more advanced technology may see less need for order-to-trade ratios; others may offer firms the ability to purchase additional capacity through extra user IDs. Meanwhile, firms do not have any incentive to overload systems because that would lead to queuing, which would lead to trading losses. Therefore it is most efficient if exchanges and platforms act as the "gatekeepers," restricting orders according to their technological capabilities, and allowing users to adapt their systems dynamically.

Risk Management
FIA EPTA agrees that firms should build into their automated systems checks that prevent the entry of orders that exceed pre-set credit or capital thresholds for clients, or that breach risk limits for individual traders, desks or the firm as a whole. However, we believe the guidelines should allow for flexibility in how firms tailor such limits to their business models. Some firms operate risk systems per trading desk, others per individual trader. Likewise, such limits should be able to be adjusted to take into account the likelihood of execution and also vary based on sector, security or other limiting factors.

Furthermore, FIA EPTA fails to understand why *Compliance* staff should have access to a real-time order feed. We see the importance of monitoring a firms' order behaviour on a real-time basis but believe this could also be done by e.g. the risk function.

Operational Risk
FIA EPTA represents principal trading firms that do not engage in client business and therefore have a lower risk profile than client-oriented trading firms. Market risk and credit risk are minimized due to centrally cleared and / or delivery-versus-payment transactions and often delta-hedged trading styles. Operational risk is the most relevant business risk for the highly automated trading environment. To protect themselves, most latency-sensitive principal trading firms invest heavily in automating their risk management systems in order to be able to signal proactively any procedural weaknesses.

In FIA EPTA's experience, however, operational risk is usually concentrated in technology events at exchanges and clearers. If an exchange's system goes down, it may be unclear whether a firm's orders have been cancelled or frozen, leaving it exposed to being hit on expired prices. Likewise, a faulty market data feed could input incorrect information into a company's algorithms and cause it to transact at a loss.

FIA EPTA therefore believes that the guidelines should grant significant discretion to firms to counter operational risk in light of their own risk appetite and based on a concept of best practices as laid out in the FIA PTG's "Recommendations for Risk Controls for Trading Firms" paper. Commercial self-preservation will motivate firms to implement controls strenuous enough to protect the firm, and thus, the markets.

Q12: Are there any areas of the draft guidelines on organizational requirements for investment firms to promote fair and orderly trading where you believe it would be helpful to have more detail?

Please refer to FIA EPTA's response to Question 11.

Q13: Do you have additional comments on the draft guidelines on organizational requirements for investment firms to promote fair and orderly trading?

Please refer to FIA EPTA's response to Question 11.

Q14: Are there any areas of the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

FIA EPTA believes that all market participants have a shared responsibility to promote fair and orderly trading, particularly to detect and deter abuses.

Trading venues have a key role to play in the policing of market abuse and in their role of promoting fair and orderly markets. They seek to ensure market integrity through real-time monitoring and market surveillance programs, and robust systems and controls. As such, it is appropriate that ESMA's policies should take into account procedures surrounding adequacy of systems, market abuse reporting mechanisms, resourcing and competency of staff and the periodic review of these, respectively.

On this basis, FIA EPTA members are supportive of the general and detailed guidelines proposed by ESMA. We would however respectfully submit the following observations and suggest that clarity be provided by ESMA on these topics.

The definition of market manipulation
Regulation and policy has, so far, evaded a distinct definition of market manipulation. Within the explanatory note to Guideline 5, ESMA references current regulatory guidance that provides definitional scope of the term and also illustrates examples of what might constitute market manipulation. We applaud this approach but would suggest that ESMA go a step further than *explanatory note 38* by providing clear examples of the specific behaviours they wish the scope of market manipulation to cover. Further clarity on prohibited behaviours would allow for better monitoring and surveillance capabilities.

FIA EPTA believes this is particularly prudent given that there has been significant confusion in the public discourse and lack of clarity around what constitutes market abuse, which only inflates the misconception in some quarters that the advancement of automated trading technologies has somehow resulted in a decline in market integrity. The marketplace as a whole would benefit from a more illustrative definition of market manipulation and examples of what constitutes the behaviour intended to be prohibited.

Indeed, in the context of ESMA's proposed Guideline 5, if exchanges and platforms have a better understanding of what regulators mean by market manipulation, they will be better able to satisfy their obligation to report such activity to the relevant authorities, as laid out in ESMA's detailed guidelines.

Q15: Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

FIA EPTA strongly urges ESMA to avoid creating a distinction in market abuse rules based on the *type* of trading participant (automated vs. non-automated) or putting the focus of market abuse rules on a type of trading *technology* rather than on trading *strategies*. Market abuse is an illegitimate trading practice, regardless of how it is carried out; it is abusive strategies (whether manual or automated) that are at issue. Any market abuse should be detected, analysed and stopped *whether* the trade was generated by a computer or by a human.

Therefore FIA EPTA urges ESMA to ensure that such guidelines are applicable to *all* types of trading participants, rather than focusing on a specific type of trading activity. Toward this end, exchanges' and platforms' operating guidelines should be applicable to all member participants, not just automated trading members. Allowing for a differentiation of rules based on the type of trading participant serves to unfairly conflate certain forms of market manipulation with a type of trading technology, rather than the strategy responsible for it.

ESMA should be clear in their delineation of what is required from exchanges and platforms in the detection of both market manipulation and market disruption.[13] While exchanges and platforms should have the tools to conduct surveillance of trading participants' activities and must report to the relevant competent authority as soon as suspicion of market abuse is raised, exchanges and platforms should and indeed can be well equipped to detect and respond to instances of market disruption (for example by employing mitigation mechanisms such as those discussed in our answer to Question 10). On the other hand, the surveillance of market manipulation proves more challenging and often will involve extensive post-analytic work on orders and trades submitted. On this basis, FIA EPTA believes that exchanges and platforms should be imbued with the authority to monitor market disruption on a real-time basis, whereas their requirements to assist regulators with the detection of market manipulation can continue to take place on the basis of post-analytical work. To the extent the guidelines include language that requires real-time reporting of market abuse, this would prove costly to implement and may not add significant value given the difficulties that present themselves in the real-time detection of market manipulation.

Finally, FIA EPTA believes the surveillance capabilities of exchanges and platforms will be both more effective and more comprehensive if complemented by surveillance by competent authorities who are able to analyse a complete data set for potential trading irregularities and improper conduct.

[13] Note that FIA EPTA is referring here specifically to market disruption whereby unusual trading (such as "fat fingering") results in a disorderly market.

A recent FSA bulletin regarding manipulative trading[14] aptly demonstrates the role of exchanges and platforms in reporting suspicious activity to regulators. In this case, an MTF reported to "the FSA suspicious conduct by one of its members, specifically a *manipulative* form of layering of the order book, which resulted in an injunction against three trading firms and freezing of their assets. In this particular case the trading firms were trading by means of DMA, however it is prudent to note that manipulative layering existed as a concept prior to the introduction of automated trading (albeit in a different fashion as traders would need to layer the book over the day) and isn't a consequence of the advances in trading technology.

It is important to leverage the strengths of exchanges and platforms in detecting and deterring market manipulation. FIA EPTA supports the general introduction of these guidelines and regards it as reasonable to require exchanges and platforms to maintain robust procedures and controls in their role as first-line regulators. We would however ask that ESMA consider the following prior to implementing such rules and guidelines:

- Any definition of market manipulation needs to be illustrative, incorporating specific examples of transgressive behaviour.
- The guidelines proffered by these specific (but not exhaustive) examples must be flexible enough so as not to discourage legitimate trading strategies.
- Rules should not be limited to particular trading mechanisms (i.e., only automated or only manual), but rather should be targeted against manipulative strategies, and not a type of technology.
- Before establishing rules and policies that would shift monitoring market abuse / manipulation from a post-analytical investigation to real-time detection and reporting, regulators should consider the cost implications of such a shift and leverage the strengths of exchanges and platforms.

Q16: Are there any areas of the draft guidelines on organisational requirements to deal with market manipulation for investment firms where you believe it would be helpful to have more detail?

FIA EPTA believes that all investment firms (whether in a highly automated trading environment or not) should have policies and procedures reasonably designed to minimise the risk that their activities give rise to market abuse. These policies and procedures should be proportionate and take into account the nature, scale and complexity of a firm's trading activities. Therefore FIA EPTA supports the general principle and detailed guidelines; however, we would suggest that it would be beneficial for ESMA to clarify the following:

The definition of market manipulation
FIA EPTA repeats its recommendations in our response to Question 14. All market participants would clearly benefit from a clarification of the definition of market manipulation. The following are examples of situations involving *legitimate* trading strategies, where the market would benefit from a more illustrative and example-led definition of market manipulation to reduce confusion:

[14] http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/077.shtml

- It is very common for liquidity seeking algorithms to post interest at several trading venues, only to pull those orders from all but one venue once they realize their desired position. This perfectly legitimate and beneficial behaviour could fall afoul of an excessively broad concept of market manipulation, as the liquidity posted on the venues where execution did not occur could be seen to represent false volumes.
- Firms will post orders to one or several venues, only to cancel and re-submit orders if their trading engines determine that the previous set of orders no longer fall within the risk parameters to which the algorithm is coded. This prudent practice could fall afoul of an excessively broad concept of market manipulation. Trading platforms already have other measures available to them to manage messaging traffic – this topic does not need to become "compliancised" by calling it a manipulative activity.
- Some critics have sown confusion by mislabeling the use of direct market data feeds from exchanges to make trading decisions as 'front running.' Front running is actually something entirely different – it is a clearly defined term for an illegal activity that occurs when a broker has non-public information about its client's orders and acts upon that information to trade ahead of the client. Basing trading decisions on market data feeds is absolutely not front running because such data feeds are available to any market participant that chooses to invest in the technology. Some high-touch and manual trading firms that have chosen not to invest in technology are now criticizing the use of electronic market data, as they apparently believe that automated trading technology that is able to read market movements in real time, and therefore make intelligent trading decisions very quickly (i.e. ahead of firms who choose not to employ market data in their trading decision making), is illegitimate behaviour. FIA EPTA strongly believes that ESMA should clarify to the market that the use of technology in and of itself does not constitute market abuse, and the reliance on publicly available market data feeds is indeed a legitimate and beneficial trading activity which enhances price discovery. This example is more controversial, given the negative media attention it has received, however aptly demonstrates an area that clearly requires intervention from regulators to illuminate their true intentions to the market and to take a constructive role in dispelling misinformation.

Arrangements for access to trading systems
It is not completely clear to us in what way a detailed requirement stating that investment firms should have policies and procedures that include *"frequently reviewed arrangements governing the access of staff to trading systems"* helps these firms in dealing with market manipulation. Whilst we appreciate that access security arrangements are highly important for firms active in a highly automated trading environment (e.g. to prevent unqualified and unauthorised people getting access to the trading systems) as any abuse of their trading systems could pose significant threats to the company, we would appreciate if ESMA could provide some clarity on these expectations, specifically with regard to their relation to market abuse.

Initial and regular refresher trainings on market abuse
FIA EPTA members believe that knowledge and understanding of the regulations relating to market manipulation are of utmost importance for the effective prevention of market abuse within an investment firm. However, we believe that the guideline stating that the policies and procedures should at least include "*initial and refresher trainings on what constitutes market abuse (in particular market manipulation) for all individuals involved in the executing orders on behalf of clients and dealing on own account"* would benefit from a more principle-based wording, stating for example that all individuals involved in the execution of orders should have sufficient knowledge and understanding of the market abuse regulations, and that they keep this knowledge up-to-date on an ongoing basis. It should be up to

the investment firm to show to the regulator how this is achieved, be it by initial and regular refresher trainings or otherwise.

Q17: Do you have additional comments on the draft guidelines relating to organisational requirements to deal with market manipulation for investment firms?

FIA EPTA supports a regulatory environment that promotes fair competition. Manipulative trading is not appropriate *regardless* of whether the orders are manually or computer generated.

Some market participants fear and misunderstand fast moving technology. The technological revolution in trading methods has confused some traditional investors - both retail and professional – and has led some of them to identify these new trading technologies as a market integrity issue. FIA EPTA believes it would be overly simplistic to blame any perceived deterioration in market integrity on the technological advancements in trading (in fact, empirical measures of market quality show improvements in liquidity, transparency, price discovery and micro-volatility in automated markets). High frequency trading, algorithmic trading and automated trading are all means to execute certain strategies, but they are not strategies themselves. Manipulative practices, unfortunately, are not uniquely employed by any particular type of market participant; rather, they have been employed by participants for many years, whether by means of automated trading techniques or not.

Thus, FIA EPTA believes that the focus of ESMA in preventing manipulative behaviour should be primarily on the *strategies* employed by investment firms, rather than on the *technologies* that are used. Any type of manipulative behaviour, whether it is manually or computer generated, should be prohibited, and existing rules against such activity should be strictly enforced. On this basis, the guidelines that ESMA has drafted for dealing with market manipulation should be equally applicable (and can in the current wording be equally applied) to investment firms that deal on own account (or execute client orders) without using sophisticated technology.

FIA EPTA also notes that that terms commonly used to describe manipulative behaviour (e.g. layering, quote stuffing, ping orders) are difficult to define, which could result in prohibitions against sometimes legitimate trading behaviour. Therefore, as discussed at Question 16, we believe that ESMA could create more certainty amongst all market participants by providing additional transparency through the provision of examples on what constitutes the type of behaviours that regulators believe should be captured by these guidelines. The ultimate desired result is that legitimate trading strategies can be clearly differentiated from those that should be considered manipulative.

Q 18. Do the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA deal adequately with the differences between DMA and SA?

FIA EPTA believes that appropriate supervision of all market access is an important tool in limiting risk to the financial markets. We do not believe that ESMA should establish different guidelines depending on the type of market access. Because all market access – whether as principal or agent and whether DMA or SA – creates risks, the same principles should apply to all market access. For this reason, FIA EPTA does not believe it is necessary for ESMA to distinguish between DMA and SA. The orders of all participants should be subject to appropriate risk management controls. When an intermediary provides a client access to the market, that intermediary should be responsible for the risk management controls.

FIA EPTA agrees that both trading platforms and investment firms have a role in limiting the risks identified by ESMA. As highlighted in the *FIA's Market Access Risk Management Recommendations*, "managing the risk of providing direct access to an RMs or MTFs trading facility is a critically important responsibility of all parties involved in the process."[15]

We believe that exchanges, platforms and investment firms have strong commercial incentives to have in place risk management controls and that, notwithstanding the considerable growth in volumes and increased speed of trading, the capabilities and execution of automated risk management systems by investment firms and exchanges and platforms are generally satisfactory. FIA EPTA supports the proposed guidelines, as they would create common expectations for all exchanges, platforms, and investment firms and their clients regarding risk management responsibilities.

FIA EPTA supports ESMA's initiative to provide guidance to exchanges, platforms, and investment firms on organizational requirements in relation to the provision of direct market access and sponsored access. To promote fair and orderly markets, the orders of <u>all market participants</u>, not just regulated investment firms, must be subject to systems and controls requirements.

FIA EPTA believes that, in many cases, risk control mechanisms should reside at the level of exchanges and platforms. Pre-trade risk controls, such as those set forth in paragraph 2 of Guideline 4 and referenced in paragraph 2 of Guideline 8, can be put in place at the investment firm or trading platform level. However, requiring exchanges and platforms to provide such basic risk management tools would provide a more uniform set of risk management controls and would eliminate the advantage that an investment firm may try to provide its clients through less responsible, but also less latent, risk management controls (i.e., the so-called "race to the bottom" problem). Nevertheless, setting the *parameters* of pre-trade controls provided by an RM/MTF should be the responsibility of the investment firm providing access to its client or of such client's clearing firm.

Responsibility
FIA EPTA agrees that a trading platform's rules should stress that the provider firm remains responsible for all trades using their market participant ID code.

Obligations of members / participants and users
FIA EPTA agrees that trading platforms should require provider firms to have adequate systems to minimize the risks of their clients disrupting orderly trading or participating in market abuse activities. However, in the explanatory notes, ESMA suggests that trading platforms be able to carry out where necessary a review of member/participants or users' internal risk control systems. Such a requirement would seem to go beyond the requirements in the draft detailed guidelines and be more prescriptive than necessary. Moreover, the Articles in MiFID on which ESMA relies do not require reviewing a member/participants' or users' internal risk control systems.

Right of Access
FIA EPTA agrees that trading platforms should retain the right to decide who is able to access their market, based on objective and transparent criteria.

[15] FIA, *Market Access Risk Management Recommendations*, April 2010.

ESMA's proposed Guideline 7 relies on Articles 14(1),[16] 26(1), 39(b) and 43(1) of MiFID. These MiFID Articles require:

- RMs to manage the risks to which they are exposed, to implement appropriate arrangements and systems to identify all significant risks to its operation, and to put in place effective measures to mitigate those risks; [17]
- RMs and MTFs to establish and maintain effective arrangements and procedures for the regular monitoring of the compliance by the members of participants with their rules;[18] and
- RMs and MTFs to establish transparent and non-discretionary rules and procedures for fair and orderly trading.[19]

In addition to these MiFID provisions, FIA EPTA believes it is important for any guidelines ESMA issues to be consistent with an exchange's and platform's responsibility to "establish and maintain transparent rules, based on objective criteria, governing access to its facility."[20] FIA EPTA does not believe that proposed Guideline 7 is inconsistent with this requirement. However, we ask that ESMA clarify that an exchange's and platform's rules and procedures regarding the right of access must be transparent and based on objective criteria.

Control over SA

FIA EPTA agrees that exchanges and platforms should have the ability to stop orders from a person trading through sponsored access separately from the orders of the provider firm. Among the principles on which FIA EPTA is founded is support for appropriate risk control mechanisms in place to promote orderly, safe and secure markets.

Q19. Are there any areas of the draft guidelines on organizational requirements for trading platforms whose members/participants or users offer DMA/SA where you believe it would be helpful to have more detail?

FIA EPTA believes that draft Guideline 7 is sufficiently detailed. It would establish standards that exchanges and platforms would be required to meet but leaves to those trading platforms discretion regarding how best to meet those standards.

Q 20. Do you have additional comments on the draft guidelines relating to organizational requirements for trading platforms whose members/participants or users provide DMA/SA.

ESMA Guideline 3 sets the organizational requirements for exchanges and platforms to promote fair and orderly markets. This Guideline focuses on the controls that trading platforms impose on their members/participants and users but is broad in its application to all access by members and participants, including access by DMA and SA clients of members or participants. Guideline 7 identifies additional risks to trading platforms when their members or participants provide DMA or SA.

However, there are certain rules and procedures identified only in Guideline 7 that FIA EPTA believes should apply to all trading on an exchange and platform, not just trading by DMA or SA clients. In particular, FIA EPTA believes that to promote fair and orderly trading, the rules and procedures of

[16] Article 39(d), applicable to RMs, is identical to Article 14(1), which applies to MTFs.
[17] Article 39(b).
[18] Articles 26(1) and 43(1).
[19] Articles 14(1) and 39(d).
[20] Articles 14(4), 42(1) and 42(3).

exchanges and platforms under Guideline 3 should also include the following, which is based on Guideline 7:

- Make clear that the member / participant or user is responsible for all orders entered under its trading code; and
- Require the member / participant or user to have adequate systems and controls reasonably designed to prevent orders sent from adversely affecting compliance with the rules of the RM or MTF, or facilitating market abuse.

In addition, FIA EPTA asks that ESMA provide more clarity on the relationship between Guideline 3 and Guideline 7.

Q 21: Do the draft guidelines on organisational requirements for investment firms providing DMA/SA deal adequately with the differences between DMA and SA?

As discussed in the response to Question 18, FIA EPTA does not believe that risk management control guidelines should distinguish between types of market access, including between DMA and SA.

As defined by ESMA, a SA client's order does not go through an investment firm's internal electronic trading system before being sent to a trading platform. If a client's order does not go through an investment firm's internal electronic trading system before being sent to a trading platform, then certain of the risk controls could reside at the level of the exchanges and platforms on which SA client orders are sent. Specifically, paragraph 2 of Guideline 8 states that an investment firm's policies and procedures should include pre-trade order controls of the sort covered in paragraph 2 of Guideline 4. For SA clients, these types of controls could reside at the exchanges and platforms.

FIA EPTA believes that ESMA's guidelines should discuss in greater detail the challenges associated with an investment firm establishing systems and controls for its SA clients.

Q 22: Are there any areas of the draft guidelines on organizational requirements for investment firms providing DMA/SA where you believe it would be helpful to have more detail?

ESMA's Guideline 8 states that an investment firm's policies and procedures should, among other things, include "an assessment, periodically reviewed, of the trading activities of direct market access / sponsored access clients to assess the potential market wide impact of the orders that are likely to be sent to the relevant [trading platform]." This requirement is too vague. It is unclear what trading activity could be considered to have a "potential market wide impact" and what assessment is supposed to be made by an investment firm of such undefined impact. In principle, all orders have a market-wide impact, as they contribute to price discovery.

Moreover, FIA EPTA is unclear the basis for ESMA to require such an assessment by an investment firm. Investment firms must have adequate arrangements in place to identify and manage the risks to their operations. The "potential market wide impact of the orders" has an unclear and attenuated connection to a firm's operations. While trading and market abuse by clients could pose risks to an investment firm, "market wide impact" is much broader than market abuse.

Q 23: Do you believe that there is sufficient consistency between the draft guidelines on organizational requirements for investment firms providing DMA/SA and the SEC's Rule 15c3-5 to

provide an effective framework for tackling relevant risks in cross-border activity and without imposing excessive costs on groups active in both the EEA and the US?

SEC Rule 15c3-5 establishes systems and controls requirements for broker-dealers that provide market access. Its principles-based approach does not impose separate or different requirements on DMA or SA. Instead, Rule 15c-3 requires broker-dealers with market access to have effective controls and procedures reasonably designed to manage the financial, regulatory, and other risks of that activity.

ESMA's proposed Guideline 4 would apply to an investment firm's highly automated activities on exchanges and platforms, including client orders. FIA EPTA understands that Guideline 4 would apply to trading activities of an investment firm's DMA and SA clients, as well as other types of clients. Guideline 8, on the other hand, applies solely to the trading of a subset of an investment firm's clients – i.e., direct market access and sponsored access clients. FIA EPTA asks that ESMA provide more clarity on the relationship between Guideline 4 and Guideline 8. In particular, the overlap between the two Guidelines is confusing and unnecessary. In addition, there are certain requirements in Guideline 8 that FIA EPTA believes would be prudent to apply to all forms of market access.

As ESMA notes, under MiFID and the MiFID Implementing Directive, investment firms are required to have adequate arrangements to identify and manage the risks to their operations. FIA EPTA agrees that these obligations include the risks to an investment firm when it offers DMA and SA to clients, but the obligations also include the risks to an investment firm when it offers other types of access to clients. FIA EPTA does not believe ESMA has adequately explained why it is limiting Guideline 8 only to trading by DMA and SA clients. All market access arrangements provided by an investment firm create risks for that firm, as well as the trading platform accessed. Accordingly, FIA EPTA believes that the policies and procedures in Guideline 8 appropriately apply regardless of the type of access an investment firm provides a client.

By combining Guideline 4 and 8, and applying the same principles-based standards to all market access provided by investment firms, ESMA would more closely align its approach with SEC Rule 15c3-5. In addition, this approach would avoid the need to carefully and uniformly apply the definitions of DMA and SA. If different or additional requirements apply to market access that falls within the definition of DMA or SA, the way in which national authorities and investment firms interpret and apply these definitions becomes critical to a European-wide set of guidelines. This type of arbitrage can be avoided by establishing one set of principles-based guidelines that would apply to all forms of access investment firms provide their clients.