Dear Lord Hollick,

Re: Regulation of high-frequency trading

Thank you for your letter of 31 July regarding the regulation of high frequency trading (HFT) and requesting our views on whether predatory trading strategies are an issue in the UK equity market and, if so, how best to tackle it.

We were interested to read Mr Katsuyama’s evidence. Mr Katsuyama talks mainly about his experience with HFT in US equity markets, however, I have limited my comments here to UK and EU regulations. It would be for the US authorities to comment on the validity of Mr Katsuyama’s remarks with respect to his US experience of HFT, and it would not be appropriate for us to comment on US regulations. However, you can be assured that both jurisdictions are alive to the potential issue.

In his evidence, Mr Katsuyama identified two types of “predatory” trading: 1) latency arbitrage, where participants use knowledge of activity on one trading venue to move quickly to another venue to execute their own business, and 2) market data arbitrage, where firms take advantage of differences in how quickly market data is received by different participants. Such strategies take advantage of predictability in order routing or information asymmetry so that the faster players can “get in front of” the rest of the market.

There are significant differences between US and UK equity market structures and this does affect how HFT strategies operate in the two markets. Such differences include variances in the level of fragmentation and geographical dispersion – in particular the extent to which trading volume is spread across multiple trading venues in the UK – and differences in regulation.

With regards to predictability of order routing, since the introduction of the EU Markets in Financial Instruments Directive (MiFID) in 2007, our rules have required firms to assess best execution – which governs order routing – by taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Therefore, a broker has discretion to adjust order
routing to avoid "predatory" strategies if these are considered to impact negatively on best execution. This reduces the predictability of order routing in the UK market.

With regards to information asymmetry, UK Recognised Investment Exchanges, such as the London Stock Exchange, are required to release trade and price data to all participants at the same time. These and other regulated markets, including multilateral trading facilities, must satisfy requirements on open and fair access to data. News is issued simultaneously to all subscribers by a listed issuer or other data collator via a Primary Information Provider (PIP), thereby reducing the opportunity for people to gain privileged information ahead of others and to trade based on that information. The so-called dark pools operated by investment firms are subject to Conduct of Business rules and the firms running them are required to treat customers fairly.

Mr Katsuyama highlighted that the way in which market data is received is an area where "predatory" firms may gain an unfair advantage. How quickly market participants receive information is dependent on a number of factors including connection speeds to the venue. If the information is released simultaneously, all firms should have the same opportunity to receive the information at the same time – any differential in their ability to do so should be due only to their willingness to invest in the relevant infrastructure. We recognise, however, the concern that cost or availability of the fastest connections may be a barrier to entry that would impact this ability, especially with regards to co-location. We have therefore included this topic in our Wholesale Sector Competition Review and are currently asking for views. Furthermore, an FCA project will be commencing shortly to study the range of information sources and fairness of information provision, specifically with respect to firms participating in HFT activity.

Market surveillance is another important part of working to ensure market fairness and cleanliness. We are conscious of the need to ensure surveillance tools keep pace with market developments and this is one reason for new requirements to be introduced as part of the review of MiFID for trading venues and firms to keep records of orders as well as trades. We have already brought a successful case against a high frequency trader who used an algorithmic programme of his own design to "layer" thousands of false orders on the ICE Futures Europe exchange.

In that case, US-based oil trader Michael Coscia placed and rapidly cancelled large orders which he did not intend to trade, with the intention of creating a false impression as to the weight of buyer or seller interest thereby "layering" the order book and manipulating the market. The FCA concluded that Mr Coscia's behaviour amounted to deliberate market abuse and fined him $903,176 as well as forcing him to disgorge the profits from his abusive trading.

Mr Katsuyama noted in his evidence that he feels that increased transparency and disclosure are the solution to the issues he highlights. We agree that these can play a role, along with other measures, in mitigating the risks of predatory HFT activity. The

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* Co-location is where a market participant pays a premium to locate the server running its algorithms next to the trading venue’s matching engine. This allows a market participant to receive market information and to submit, amend or cancel orders with less latency – i.e. more quickly - than participants that are not co-located.
1 http://www.fca.org.uk/your-fca/documents/market-studies/wholesale-sector-competition-review-call-for-inputs
2 http://www.fca.org.uk/your-fca/documents/final-notices/2013/michael-coscia
strict requirements to be introduced following the MiFID review will introduce a wide range of new requirements for HFT activity. These will include substantial transparency and disclosure requirements for trading venues and investment firms, such as record keeping requirements for trading venues to maintain order data in addition to transaction data, a documentation requirement for algorithms deployed by investment firms and a requirement for trading venues to establish fair, non-discriminatory and transparent fee structures, taking into account the possibility of excessive orders being posted by participants.

We consider that, due to differences in market structures between the US and UK markets, the opportunities for the types of predatory practices identified in Mr Katsuyama’s evidence are fewer in UK markets. We have rules in place to ensure fair and non-discriminatory access to information and have the power to enforce against any breaches we discover. But we are not complacent. We continue to assess how the market is evolving and, via our market monitoring, continue to identify and address any behaviour that threatens market integrity.

I hope this is helpful to the Committee.

PP.

Martin Wheatley
Chief Executive