Rt Hon Greg Clark MP,
Financial Secretary to the Treasury,
HM Treasury,
1 Horse Guards Road,
London, SW1A 2HQ

26 March 2013

Dear Mr Clark,

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) welcomes 'Foresight: The Future of Computer Trading in Financial Markets (2012) Final Project Report'. CFA UK is keen to share its observations about the report's contents; and hopes these are useful. This letter has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC). The PSMPC identifies and monitors key regulatory and best practice developments likely to affect CFA UK members

Foresight: The Future of Computer Trading in Financial Markets (2012) Final Project Report

Context

CFA UK members work across a variety of markets and asset classes. The society has an interest in any initiative that assesses the impact of market practices on market integrity, but has no bias in preferring one type of market participant or approach over another. The evidence that has emerged since the financial crisis has revealed that inappropriate activity can be conducted by a variety of market participants in both the cash and derivative markets across all asset classes. Policymakers and regulators have tended to identify convenient scapegoats, rather than focusing on the structural issues and behaviours that undermine market integrity.

We are agnostic with regard to investment horizons. In our view, there is no optimal holding period. The holding period is one to be determined by the investor or the end beneficiary. To achieve the benefits of diversification and the required risk adjusted returns, investors may use a variety of asset managers operating different investment approaches.

CFA UK members abide by the CFA Institute's Code of Ethics and Standards of Professional Conduct (summary enclosed). One requirement in the Code and Standards is to 'promote the integrity of and uphold the rules governing capital markets'. The Code and Standards would either complement or enhance CFA UK members' compliance to their UK regulatory requirements. For example one of the FSA's Principles for Business, (Principle 5) requires firms to 'observe proper standards of market conduct'. Principle 5 was found to have been breached by the UK banks involved with the manipulation of Libor and encouraged the UK regulator to take action.

Evidence based policymaking and overemphasis on equity markets

CFA UK believes that regulatory initiatives have too often been targeted at symptoms, rather than root causes. Evidence-based policy-making has been more the exception than the norm. CFA UK welcomes the report into High Frequency Trading and Algorithmic trading (HFT/AT) as a valuable example of evidence-based analysis.

We hope that the report's reception encourages policy-makers to focus on root causes rather than symptoms and to base policy on rigorous analysis of extensive evidence. While we understand why HFT/AT participants have attracted attention, it appears to us that the primary cause for concern should be the broader scope and potential for market disruption. All types of market participants have the potential to undermine market integrity and this risk is not limited to the equity markets alone.

Market integrity is vital for the appropriate pricing of risk and the efficient allocation of capital across all markets, not just equity markets. The focus on HFT/AT has diverted attention away from other more serious failures that have emerged since the crisis broke; Libor being a prime example. In addition, this project, the Kay Review, and other initiatives have all focussed on the equity markets. There is a need for the UK Government to appreciate that investors, businesses and our profession are active in equity and non-equity markets and use a variety of instruments to meet their needs. Further, the credit markets are an important source of funding for UK plc.

It appears to us that regulators and policymakers should:

1) Focus on conduct, intent and practices rather than devote too many resources into assessing the means by which market participants interact with the markets. Deterring inappropriate market practices through policy targeted at incentives and culture should be the primary objective.

2) Balance better their interest in equity and non-equity markets. Inappropriate market conduct should be deterred across all types of cash and derivatives markets.

3) Place greater emphasis on effective supervision and enforcement so that there is a credible deterrent for inappropriate behaviour. It is more productive to address conduct within market rather than attempting to restrict the operation of a market (an approach which is likely simply to lead to a temporary displacement of a market).

4) Undertake evidence-based policy-making and regulation. Evidence[1] should be drawn to demonstrate that new policies or regulations will be effective and enforceable.

The onus is on the regulator to ensure that it has the quality of resources to detect attempts to undermine market integrity. We accept that this may be challenging especially as the methods used become more sophisticated and complex. Taking a symptom-led approach to try and constrain the mechanics of how market abuse may occur will not reduce the potential for such abuse to occur in the future. Regulators and policymakers should focus on understanding the different ways by which market abuse can take place rather than placing too much emphasis on a specific approach, such as HFT/AT.

It is worth pointing out the recent efforts made by regulators in the US to improve their understanding of the market microstructure issues which, we believe, is a fundamental precursor to any regulatory intervention[2]. The SEC's increasing focus on learning the details of algorithmic trading, for instance, will only help the Commission make better decisions on market structure policy. The SEC is attempting not only to understand what high-frequency trading is, but also the tools and technology being used by high-frequency traders and how

[1] The SEC has held a number of roundtables at which market participants were given the opportunity to explain definitions, defend market practices and point out requirements that they believe will make the markets fair. Everything from dark pools to high-frequency trading has been discussed.

[2] In January 2013, FINRA, along with the SEC, announced that they had identified “concerns” about alternative trading systems and would be conducting a series of examinations of firms that operate ATSs as well as exams of the firms’ affiliates. In March 2013 it was reported that the SEC was teaming with the FBI to investigate algorithmic trading. Examiners at the SEC who specialize in computerized trading strategies (The new Quantitative Analytics Unit, which has been examining abuses related to HFT and dark pools) have started sharing their expertise with the FBI and vice versa. It appears that there was not any one incident that prompted the cooperation between the agencies; rather, it is the beginning of a long-term educational exercise.

they could be used to manipulate the market. This is a different and important initiative. We appreciated the recent observation by David Wright, Chairman of IOSCO, using an analogy for the position of regulators: *"We're being asked to regulate a power station without understanding what the pipes and dials are for."*

We trust that these comments are useful and would be pleased to meet with senior officials to explain them or to develop them.

Yours,

Natalie WinterFrost, CFA FIA
Chair Professional Standards & Market Practices
Committee, CFA UK

Will Goodhart
Chief executive
CFA Society of the UK

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About CFA UK and CFA Institute

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.