



June 12, 2009

**Via Electronic Mail:** [corina@iosco.org](mailto:corina@iosco.org)

Mr. Greg Tanzer  
IOSCO General Secretariat  
C/ Oquendo 12  
28006 Madrid  
Spain

**Re: Public Comment on Policies on Direct Electronic Access**

Dear Mr. Tanzer:

Managed Funds Association (“MFA”)<sup>1</sup> welcomes the opportunity to provide comments to the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) on its Policies on Direct Electronic Access Consultation Report (“Consultation Report”) as it determines whether it is appropriate to provide guidance regarding direct electronic access (“DEA”).<sup>2</sup>

MFA members are active users of electronic trading services and provide liquidity to markets and contribute to pricing efficiency as DEA customers (“Customers”). MFA believes that DEA is an important trading alternative for its members, and appreciates the Technical Committee’s fact-finding survey of DEA models and practices. As part of the Technical Committee’s review, we believe the Technical Committee should issue its survey to DEA Customers in order for IOSCO to gain a complete picture on the use and risks of DEA. Our members offer a relevant perspective as DEA Customers and would appreciate the opportunity to respond to the Technical Committee’s DEA survey to share their experience and perspective with the Technical Committee, along with markets (“Markets”) and intermediaries that are market members (“Intermediaries”). Below, MFA provides comments to the Consultation Report.

## **I. INTRODUCTION**

The Consultation Report sets forth and seeks comments on proposed principles with respect to DEA (“Proposed Guidance”), including pre-conditions for DEA, information flow and adequate systems and controls. The Consultation Report defines DEA as the following practices:

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<sup>1</sup> MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

<sup>2</sup> Policies on Direct Electronic Access, IOSCO Consultation Report, February 2009, *available at:* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD284.pdf>.

- Automated order routing through intermediary's infrastructure ("AOR") – where an Intermediary permits its customer to transmit orders electronically to the Intermediary's infrastructure, where the order is in turn automatically transmitted for execution to a market under the Intermediary's market maker ID (mnemonic).
- Sponsored access ("SA") – where an Intermediary allows its customer to use its member ID to transmit orders for execution directly to the market without using the Intermediary's infrastructure.
- Direct access by non-intermediary market-members ("Direct Access") – where an entity that is not registered as an intermediary becomes a market-member, and in that capacity connects directly to the market's trade matching system using its own member ID (mnemonic) (*e.g.*, the Customer is the Market member).

Our members are AOR, SA and Direct Access Customers that trade in equity markets and futures and options markets. We appreciate the need for regulatory oversight and controls with respect to DEA and believe that Proposed Guidance should also incorporate investor protections. We believe a one-size-fits-all approach would overlook the important differentiating DEA features and relevant Market regulations and limitations. The equity markets and the futures and options markets have sufficiently different regulations that guidance relevant to one market may not be applicable to the other. Also, general guidelines do not recognize that the three types of practices defined as DEA are suited for Customers with different risk profiles and are supported by distinct sets of technical capabilities. We believe Markets with input from Intermediaries and Customers, should provide guidance with respect to each type of DEA practice. In our view, a single set of principles would be inadequate. Further, any guidance provided should not be so restrictive that it would inhibit the development of technical advances.

## **II. COMMENTS**

MFA firmly supports that Markets and Intermediaries should have appropriate policies and procedures in place that seek to ensure that customers granted DEA will not pose undue risks to the Market and the relevant Intermediary. In addition, MFA believes that it is equally important for these policies and procedures to address confidentiality of Customer trade data to protect against market manipulation, fraud and even systemic risk. MFA believes a key component that is currently missing in the Proposed Guidance is a principle relating to confidentiality of trade data and any other proprietary information provided by a Customer pursuant to a DEA agreement (herein referred to as "Trade Data").<sup>3</sup>

### **A. Confidentiality Safeguards**

MFA believes the Proposed Guidance should include a principle on confidentiality safeguards and controls to protect the Trade Data of Customers and to assure investors that the recipients of such information would use it exclusively for regulatory purposes. MFA supports

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<sup>3</sup> See letter from Stuart J. Kaswell, Executive Vice President and General Counsel, Managed Funds Association to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 24, 2009, available at: <http://www.managedfunds.org/downloads/MFA.Sponsored%20Access.2.24.09.final.pdf>.

the premise that a Market or Intermediary should have access to necessary Customer information to allow them to comply with their regulatory requirements, including monitoring for potential illegal activity. We submit, however, that Markets and Intermediaries should have robust policies and procedures that include confidentiality safeguards and controls to protect a Customer's Trade Data, and that these obligations should be meaningful and enforceable by a Customer.

A Customer's trading data constitute highly proprietary information that, if made publicly available, could be used to reverse engineer trading strategies. Moreover, access to Trade Data could create opportunities for front-running, market manipulation, fraud and systemic risk through copycat strategies. We are particularly concerned with the potential risk that employees of a Market or of an Intermediary's proprietary trading division could access and misuse Trade Data to front-run a Customer's trades or to reverse engineer its trading strategy. Thus, we believe that the Proposed Guidance should recommend that Markets and Intermediaries implement and enforce confidentiality safeguards and controls, including information barriers, to protect a Customer's Trade Data.

Further, we believe the Proposed Guidance should provide that a Market only will use any information that it obtains exclusively for regulatory purposes and that the Market will maintain the confidentiality of such information. As Markets these days generally are for-profit entities, we are concerned that a Market may misuse Trade Data for business development purposes. The Proposed Guidance should recommend that a Market include certifications with respect to its confidentiality safeguards and controls, such as:

- The Market will use Trade Data exclusively for regulatory purposes and will not use it in any commercial way;
- The Market will make Trade Data available only to officers and employees who are responsible for regulatory functions, directors that are involved in regulatory functions (*e.g.*, an appeal of a disciplinary matter), or agents to the extent necessary to perform the regulatory function for which they have been hired; and
- The Market will implement and enforce policies and procedures, and maintain information barriers between its regulatory division and other business divisions.

To the last point, we believe that strict guidelines should be instituted by Markets, providing that Trade Data obtained through its regulatory function shall not be used for private, commercial gain. We submit that it is inappropriate for a Market, or any organization with regulatory responsibilities, to use Trade Data obtained through the auspices of its regulatory responsibilities for private, commercial purposes.

Accordingly, we recommend that the Proposed Guidance incorporate confidentiality safeguards with respect to a Market's possession and use of Customer Trade Data, including the certification by Markets of the maintenance and enforcement of policies, procedures and controls to protect Trade Data, and that Trade Data will be exclusively used for regulatory purposes.

## **B. Pre-conditions for DEA**

MFA supports the principle that Customers should be required to meet minimum standards. As discussed in the Consultation Report, and experienced by our members, Intermediaries use a vetting process to determine on a case by case basis whether it will grant a customer DEA. We believe this process, which includes an analysis of the entire risk profile of a potential Customer, whether the potential Customer has adequate systems and controls to monitor orders and trades, and a review of the potential Customer's level of sophistication, is a critical component of DEA and greatly reduces market and credit risk from a Customer's use of DEA. The Consultation Report reports that in SA arrangements, some Markets restrict Customer access to certain types of institutional investors. We believe it is appropriate for the Customer standards for SA and Direct Access to be higher than for AOR.

The Consultation Report also proposes that there should be a recorded, legally binding contract between an Intermediary and its Customer, the nature and detail of which should be appropriate to the nature of the service provided. We concur with this principle. We believe that a contract between an Intermediary and its Customer serves the useful purpose of delineating the rights and responsibilities of the parties, as well as the terms of the DEA service agreement, such as trade limits, termination events, and grace and cure periods.

## **C. Information Flow, Systems and Controls**

### *(1) Customer Identification*

MFA supports the premise that a Market should have access to necessary Customer information to allow it to comply with its regulatory requirements. We agree with the Proposed Guidance that "Intermediaries should disclose to market authorities upon request and in a timely manner the identity of their DEA Customers in order to facilitate market surveillance." Again, we expect Markets to treat Customer information provided by an Intermediary with an appropriate level of sensitivity and confidentiality.

### *(2) Latency and "Fairness"*

Markets offer a number of pathways for members to connect to the trade matching system; each of which carries differences in response times due to differences in connection technology. The Consultation Report refers to the elapsed time between the transmission of a transaction from the Intermediary's system and the receipt of that transmission by the Market server for execution as "latency." Generally, SA and Direct Access Customers are high-speed, high-volume traders. For these market participants, including many hedge funds, their primary objective is to provide their investors, to whom they have a fiduciary duty, with the highest-quality execution possible at the least cost. In this respect, Customers are critically concerned with latency as delays can result in poor trade execution quality, increased costs to investors, as well as make it harder for the Customer to achieve its investment objectives.

We believe it is possible to reduce latency while enhancing regulatory compliance and oversight, and that the two objectives are not mutually exclusive. We believe latency should be addressed from both a regulatory and technical perspective. We submit that any regulatory requirements or guidelines concerning DEA should avoid creating competitive disadvantages for

Customers; consider the technical capability of Markets and Intermediaries; and ensure order transmission consistency within a Market and across Intermediaries.

(3) *Pre and Post-Trade Information*

MFA supports the use of risk controls to monitor a Customer's DEA trading activity, such as the performance of post-trade analysis by Intermediaries or Markets. Our members' primary concern with DEA order transmission is latency and its impact on best execution for their investors. This concern is elevated by the prospect of an Intermediary conducting pre-trade analysis. Intermediaries have varying technical capabilities, which affect the degree of latency and raise the risk of creating a competitive disadvantage for Customers. In addition, Customers are concerned with the increased risk that employees of an Intermediary could front-run a Customer's orders.

We believe there are ways to effectively implement oversight while minimizing latency concerns; and that a Market and Intermediaries should have flexibility in determining the appropriate method of regulation for each type of DEA depending upon their own regulatory and technical capabilities and legal requirements. We provide two recommendations with respect to pre-trade controls that would address both compliance and latency concerns.

*(a) Markets should provide general principles with respect to "reasonable" pre-trade controls and allow (SA and Direct Access) Customers to build pre-trade controls into their own trading system.*

Given the regulatory and technical differences amongst the international market centers, and between the equity and the futures and options markets, we believe Markets, with input from Intermediaries and Customers, should provide general principles with respect to "reasonable" pre-trade controls. Customers should be allowed to build and develop "reasonable" pre-trade controls as established by the Market into their internal systems.

In considering risk management responsibilities, we believe it may be appropriate to analogize to the broker-dealer regime, where pursuant to Carrying Agreements such as former NYSE Rule 382 or Proposed Financial Industry Regulatory Association Rule 4311,<sup>4</sup> an introducing firm and a clearing firm must allocate responsibility amongst themselves to address certain basic regulatory functions. Similarly, in this context, we believe it may be appropriate for a Market to require that certain standard risk management controls be met and to leave it to an Intermediary and its SA or Direct Access Customer to legally agree both upon the procedures through which the Customer shall enact pre and post trade controls, and the manner by which the Customer will demonstrate such controls to the Intermediary's satisfaction. We believe the Customer should be able to demonstrate to its Intermediary that it enacts these controls obligations, such as through periodic reports or similar methods.

MFA members believe the opportunity to build and develop their own pre-trade controls would be preferable to requiring an Intermediary to conduct pre-trade analysis. Such solution would address regulatory concerns with respect to pre-trade controls, as well as address Customer

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<sup>4</sup> Proposed Financial Industry Regulatory Association Rule 4311 (Carrying Agreements) can be found at: [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=7370](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7370).

concerns with latency and the risk of their orders being front-run by employees of an Intermediary.

*(b) A Market should conduct pre-trade analysis, either internally or in conjunction with a vendor.*

Alternatively, we believe a Market should conduct pre and post trade analyses. Having a Market conduct pre-trade analysis would limit Customers' concern with latency, because all orders would be subject to the same controls. Similarly, we believe a Market should be permitted to outsource the responsibility of conducting pre-trade controls to a vendor, so long as all orders to the Market pass through the vendor's pre-trade controls and provided that the Vendor is subject to the confidentiality safeguards discussed in Section II.A above. Such solution would alleviate Customer concerns regarding competitive disadvantages created by latency issues across Intermediaries and between Customers and Intermediaries. It would also assure Customers that they were obtaining best execution on behalf of their investors. Further, we believe a Market is likely to have greater ability and incentive than an Intermediary to maintain systems to process high-speed, high-volume trade orders.

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Accordingly, we recommend that Markets provide general principles with respect to "reasonable" pre-trade controls and allow (SA and Direct Access) Customers to build pre-trade controls into their own trading systems. Alternatively, we recommend that a Market conduct pre-trade analysis, either internally or in conjunction with a vendor.

### III. CONCLUSION

MFA appreciates the opportunity to share our views with respect to the Proposed Guidance on DEA. From the Customer's perspective, we believe that any Proposed Guidance on DEA would be incomplete without addressing Market and Intermediary confidentiality safeguards and controls to protect Customer Trade Data and to assure investors that the recipients of such information would use it exclusively for regulatory purposes. We believe Intermediaries should maintain minimum Customer standards for DEA service and should have adequate operational and technical systems to manage their DEA systems. We strongly believe, however, that there are a few ways to effectively implement risk oversight and that a Market and Intermediaries should have flexibility in determining the appropriate method of regulation for each type of DEA depending upon their own regulatory and technical capabilities and legal requirements.

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We would be happy to discuss our comments at greater length with the Technical Committee. If the Technical Committee has questions or comments, please do not hesitate to call Jennifer Han or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

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