



Alternative Investment Management Association

Mr Scott O'Malia
Commissioner
COMMODITY FUTURES TRADING COMMISSION
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By email to: somalia@cftc.gov

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Dear Commissioner O'Malia,

Suggested definition: High Frequency Trading

AIMA has noted with interest your suggested definition of the term High Frequency Trading ("HFT"), for discussion at the forthcoming meeting of the CFTC's Technology Advisory Committee ("the Committee") and, whilst we appreciate that you have not asked for public comments on your proposal, we trust that you will not object to us raising some points before the Committee meets.

The issue of the appropriate regulatory treatment of HFT is of great importance to our members and is the focus of much attention in both the US and the EU - in the latter, the debate focuses mainly around the ongoing revision of the Markets in Financial Instruments Directive (MiFID). We would hope that the current concentration of attention on HFT will not make those participating lose sight of the benefits to the market of using automated systems, including enhanced price discovery, reduced transaction costs, increased ability to provide best execution to investors, ensuring fair allocation of orders and mitigating 'preferential treatment' of one client over another which could happen with performance-driven discretionary trading and potentially decreased risk of rogue trading.

Whilst the key factor which allowed for the development of HFT is the use of computer technology, we assume it is not the intention of your proposal that "[t]he use of computer programs or algorithms for automated decision making where order initiation, generating, routing, and execution are determined by the system without human direction for each individual trade or order" should be seen as the central and determining feature of HFT definition. If it were, it would also capture medium/long term trend-following strategies (and other quantitative systematic strategies) since these have both 'investment' and 'execution' algorithms.

For most CTAs, a significant proportion of trades is now executed by computers with human involvement being restricted to oversight. As we argue below, we believe that it is the risk which a specified trading strategy might pose to the market which should be the key consideration as to the appropriate level of regulatory supervision, rather than the means by which it is undertaken (i.e., whether through the use of a computer or by human activity). It would be anomalous, for example, if CTAs were forced to carry out their trading with increased human involvement in order to mitigate the effect of overly burdensome new regulation.

We have, therefore, read the bullet points which you propose as being collectively, rather than individually, indicative of HFT - to be so classified, a firm would presumably be required to satisfy a number or all of the criteria, rather than any single one. Indeed, as IOSCO recognised in its July 2011 consultation paper, "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency", whilst HFT is a type of algorithmic trading, not all forms of algorithmic trading can be described as high frequency.

We see certain difficulties in the suggested bullet points which you suggest as the starting point for the Committee's work. Chief among these is the fact that, although each bullet point may, if taken individually, describe a particular characteristic which some HFTs show, it is equally the case that each criterion would also capture other firms who would not reasonably be regarded as HFT. By way of a few examples we would like to point out some of the difficulties associated with the criteria proposed to define HFT:

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- The use of extraordinarily high-speed order submission/cancellation/modification systems with speeds in excess of five milliseconds or generally very close to minimal latency of a trade

We feel it would be beneficial to regulators and to market participants alike if the discussion around HFT could be steered away from an over-concentration on questions of speed. While we accept that there could be a physical limit to how fast an order can be executed, it is fair to say that what may appear fast today may well be regarded as slow in the not too distant future and by setting specific thresholds, a regulator runs the risk of either not capturing the intended target of its rules or having to amend its detailed rules as technology develops.

- The use of co-location services, direct market access, or individual data feeds offered by exchanges and others to minimize network and other types of latencies;
- Very short time-frames for establishing and liquidating positions;
- High daily portfolio turnover and/or a high order-to-trade ratio intraday; and
- The submission of numerous orders that are cancelled immediately or within milliseconds after submission;

While relevant to HFT, these criteria are also characteristic of other types of trading - such as conventional ex-local or non-HF day trading - which the CFTC does not appear to be looking to capture in its definition. For example, high order-to-trade ratios could equally be indicative of simple arbitrage or market making strategies and further, these various attributes may be characteristic of the algorithmic trading strategies employed by the many firms that act as portfolio managers in order to comply with their regulatory (and/or fiduciary or contractual) responsibilities, in particular their agency duty to act in the best interests of their customers by striving to achieve best execution.

- Ending the trading day in as close to a flat position as possible (not carrying significant, un-hedged positions overnight)

This would, we believe, also apply to day traders who are not engaged in anything close to HFT, as well as to any form of intra-day liquidity provision, which is essential to the efficient transfer of risk between longer-term traders. We are concerned that inclusion of such a provision might, if anything, tend to lead some market participants to opt for un-hedged overnight positions where they currently close these out - this will result in a higher level of unmanaged risk, which is not the intention of the CFTC's definition.

Developing a workable definition of HFT may prove extremely difficult. Either in parallel with or in place of a set of criteria such as those proposed, we believe that a good starting point would be to consider what is the perceived market harm which might require regulatory oversight. Such a market harm or failure need not be necessarily unique to HFT. We believe that many forms of HFT, e.g., passive market making and arbitrage strategies, have been shown in academic literature to provide benefit to the market. Accordingly, we believe that one focus of attention should rather be on defining trading through its potential to disrupt the markets were problems to arise, regardless of whether carried out by a human, or a computer or at high speed or at low speed. In the context of this current debate, therefore, we would welcome the Committee considering issues such as what are the appropriate pre-trade risk controls which should be employed.

You have initiated an important and highly interesting debate by your proposed definition. AIMA and the members of its Working Group will be following the outcome with great interest and would be more than happy to play an active role in any way you consider might be appropriate to the CFTC's work. We trust that our comments above are of some assistance to you as this work gets underway.

Yours sincerely,

A handwritten signature in black ink that reads "Andrew Baker". The signature is written in a cursive, flowing style.

Andrew Baker
Chief Executive Officer