

May 2018

Response to IOSCO Consultation Report:
*Mechanisms used by trading venues to manage extreme
volatility and preserve orderly trading*



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Background

The World Federation of Exchanges (WFE) is the global trade association for exchanges and clearing houses, representing more than 200 Market Infrastructure Providers. Our members include exchange groups and standalone CCPs.¹

Our members are both local and global, operating the full continuum of market infrastructures in both developed and emerging markets. Of our members, 36.8% are in Asia-Pacific, 42.6% in EMEA and 20.6% in the Americas. WFE exchanges are home to nearly 45,000 listed companies, and the market capitalisation of these entities is over \$82.5 trillion; around \$81.8 trillion (EOB) in trading annually passes through the infrastructures WFE members safeguard.²

The WFE works with standard setters, policy makers, regulators and government organizations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence, and promoting economic growth.

Introduction

The WFE welcomes the opportunity to respond to this consultation report. The preservation of orderly markets is integral to markets' integrity, and core to exchanges' social purpose. Systems to manage extreme volatility enhance investors' confidence and contribute to the maintenance of public trust in the financial markets. The mechanisms exchanges use to preserve market orderliness must be reflective of the markets' structure, technology and their local context. Given the developments in markets over the last decade and the accumulation of experience in volatility management techniques on electronic markets, this initiative by IOSCO is timely.

The WFE believes that global markets should have global standards, implemented by national authorities co-operating to support international regulatory coherence. Because market structures vary between jurisdictions, it is important that global standards allow for appropriate flexibility in national implementation. In 2016, the WFE surveyed its membership regarding circuit-breakers and published a report based on our findings. The WFE also recently published a report which examines the array of processes and policies in place to support market integrity. This response has been developed based on this research and consultation with experts in The WFE's membership.

The WFE is in broad support with IOSCO's recommendations in the consultation report. The intention of this response is to contribute to the debate about how volatility controls can most effectively protect investors and ensure that markets are fair, efficient and transparent.

¹ The WFE membership list [can be found here](#)

² As at end 2017

Executive Summary

We welcome and support the initiative of IOSCO to set out recommendations for authorities and exchanges to consider when designing and implementing volatility control mechanisms.

We generally note:

- The WFE concurs with IOSCO about avoiding one-size-fits-all templates for volatility control (including their calibration) and encourages policymakers and regulators to adopt a principles-based approach. Venues must have the ability to tailor systems and controls to meet the needs of their markets and market participants, in consideration of their respective market environments;
- We believe that VCMs are most effective when the costs and benefits of interventions are carefully analysed. The observed efficiency of these tools should be regularly examined against their objectives;
- The WFE welcomes IOSCO's recommendations on communications between exchanges during periods of market stress. Such communication should be primarily undertaken according to market operators' judgement, rather than overly mechanistic rules;
- We believe that public communication around the triggering of volatility controls must avoid unintentional encouragement of pro-cyclical behaviour.

WFE Comments

Recommendation 1 – Trading venues should have appropriate volatility control mechanisms

Volatility controls contribute to price continuity, price quality and the probability of execution of market orders. The aim of volatility controls should not be to prevent *all* volatility, but rather to ensure that markets are able to deliver orderly price formation in the context of extreme volatility. Volatility controls are a means to ensure investor protection and appropriate price formation and should be deployed with these objectives in mind. The interests of an orderly market should be central to the design, calibration and implementation of volatility controls. Trading venues should retain discretion on imposing any volatility controls, taking into consideration individual product characteristics and their respective market dynamics, as intervention might undermine market efficiency.

Recommendation 2 – Calibration of volatility control mechanisms

Volatility controls are one mechanism in a broader toolkit of measures to promote market integrity. Exchanges and market participants operate within statutory regulatory frameworks including conduct rules and prudential requirements to ensure investor protection and systemic stability. Exchanges publish trading rules and conduct market surveillance. Market participants, meanwhile, must have their own systems and controls to manage risk and ensure appropriate protection for their clients.

Regulators and exchanges ought to design volatility control mechanisms holistically, taking into consideration the relevant market conditions, including:

- market liquidity;
- market volatility (in consideration of volatility drivers and characteristics);
- levels of algorithmic trading;
- available order types;
- market-maker rules and;
- linkages between derivatives and underlying assets.

Algorithmic and high-frequency trading methods support liquidity and the continuity of trading during periods of market stress. Testing of both algorithms and volatility control mechanisms is crucially important to the development of an effective framework.

Recommendation 7 – Communication to market participants and the public when a mechanism is triggered

Public communications around the triggering of volatility controls should avoid unintentionally encouraging pro-cyclical behaviour. Volatility controls allow for a cooling-off period during which investors may integrate new information and/or re-appraise their strategies. Indeed, investor/trader behaviour is at the core of volatility management. It is important that brokers—as investor’s touchpoint in the market place—play their role. For example, changes to market microstructure brought about by algorithmic techniques may mean that certain order types (e.g. stop-limit or stop-loss orders) may no longer serve as an effective risk mitigation for retail investors. Some market operators such as the NYSE have started addressing the issue by phasing out stop-orders and good-till-cancelled orders³. However, ensuring that investors are appropriately informed about volatility, risk and control mechanisms is crucial.

Recommendation 8 – Communication between trading venues

As noted in the consultation report, it may be appropriate for dual-listed securities and linked securities (e.g. shares and corresponding derivatives) to be simultaneously subject to volatility controls. However, the desirability of such a measure is dependent on the circumstances giving rise to the volatility.

For example, extreme volatility caused by an erroneous order for a single stock may be appropriately mitigated by the imposition of an isolated control mechanism. On the other hand, volatility associated with market-sensitive information entering the public domain in an uncontrolled manner may precipitate wider movements in the price of derivatives contracts and exchange traded products. In some instances, exchanges ought to have discretion to examine the source of volatility and determine the most appropriate response. For this reason, any coordination of volatility controls should be at the discretion of the trading venues rather than by regulatory fiat.

In order to assist members and non-members in reacting quickly to market-wide and system-threatening events, the WFE provides an emergency contact book to enable exchanges to find a joint approach to emergency events.

Further comments

Allowing for flexibility and continuous improvement

Given the fast-changing nature of modern financial markets, it is important that exchanges can modify and improve the design of volatility controls as circumstances dictate. As such, the WFE encourages policymakers and regulators to take a principles-based approach, avoid overly proscriptive rules and assess the impact of the regulatory framework at appropriate intervals.

Inevitably, volatility and market stress will manifest themselves in different ways. While dramatic “flash crashes” on closely-followed equity market indices may be the most visible manifestation of excessive financial market volatility, these events are relatively rare. Extreme volatility and the triggering of associated control mechanisms are more likely to occur in illiquid markets⁴. Volatility control mechanisms may also be triggered when new information, affecting a security’s value, is made public. Adherence to policies governing the disclosure of market-sensitive information is one means of facilitating fair and orderly trading.

The WFE encourages regulators to work with exchanges and market participants to understand these dynamics and respond in a way that reflects public consultation and evidence-based policy design.

³ NYSE: [Elimination of Stop and GTC Order Types](#) (November 2015)

⁴ The Brookings Institute: [Market Liquidity: A Primer](#) (June 2015)

Efficiency and proportionality

Amongst the rationales for volatility controls is the promotion of orderly price discovery. However, as acknowledged in the consultation report, “too much intervention can undermine market efficiency”⁵ As markets near a price threshold, traders may take more aggressive positions in anticipation of a trading halt. When trading is suspended – rather than shifted to an auction process – price discovery is inhibited.

If trading in associated derivative markets is also suspended, investors may not be able to appropriately manage their risks in derivatives markets - particularly important during periods of market stress. For this reason, those designing volatility controls must carefully weigh the costs and benefits of the proposed mechanism, considering the tools’ objectives, and their observed efficacy.

To achieve such proportionality, exchanges and/or regulators should have latitude to implement volatility controls reflective of conditions on their markets.

The WFE welcomes IOSCO’s focus on encouraging the communications between exchanges based on judgement and appropriateness, rather than a mechanistic approach. The WFE looks forward to continuing its role in facilitating cross-border collaboration

Conclusion

The WFE and its members are committed to ensuring that their markets offer a fair, efficient and transparent environment for all market participants.

The WFE welcomes the international debate about VCMs and agrees with the IOSCO’s recommendations, aiming to strengthen the financial system and increase market confidence whilst reducing systemic risk. Investor confidence in public markets is of crucial importance to the economy. Appropriate safety mechanisms are vital to sustain market integrity and preserve public trust in the financial system.

We will continue working towards our shared objectives of fair, robust and secure markets in which investors can have confidence. The WFE would welcome any further engagement with IOSCO on these issues, should that be helpful.

5 IOSCO: [Mechanisms Used by Trading Venues to Manage Extreme Volatility and Preserve Orderly Trading](#) (March 2018)