

Priorities for ensuring the stability and efficiency of cash markets



This document was drafted by Eurofi with input from its members. It does not engage in any case the French Presidency of the G20 or the French financial authorities.

Executive summary

Major changes driven by technology and regulatory reforms have transformed the way trades are executed in cash markets in the recent years: increasing competition among trading venues, expansion of computer-assisted algorithmic (algo) trading and particularly high frequency trading (HFT)¹ which is estimated to represent now around 40% of exchange volumes in the EU and 70% in the US, development of dark pools and broker crossing networks² (BCNs) without pre-trade transparency³ which are estimated to account for 5 to 10% of volumes. Short selling has also attracted increased regulatory interest. Regulators around the world are at present assessing the potential impacts of these developments on the integrity, efficiency and stability of cash markets and on the quality of price discovery.

While recognizing the potential merits of HFT and short selling in terms of stimulating market activity, enhancing competition, providing liquidity and facilitating price formation, regulators are concerned by the market dislocation risks posed by these techniques in exceptional circumstances and the potential impacts on investor confidence. For example (1) price swings during the May 6th 2010 flash crash caused by the automated execution of a large sell order by a mutual fund in a context of markets with no circuit-breakers and (2) downward short selling pressures on certain securities, notably financial stocks in 2008. The increased difficulty for institutional investors to execute large orders on lit venues as a consequence of order size reduction in these venues due to HFT activity has also been put forward.

“Dark trading” (i.e. with no pre-trade transparency) is also being closely examined. It is considered by some sources widely endorsed by regulators to account for around 40% of equity trading volumes in the EU (including dark pools, BCNs and pure OTC). This figure of 40% is nevertheless disputed by sell-side participants who consider that at most 10% would represent actual addressable liquidity [potentially executable in lit venues]. Regulators are concerned by the possible impacts of developing dark trades on the reliability of the price discovery process, which could foster information asymmetry leading potentially to higher prices and lower investor confidence. Supervisors also point out that limited visibility on dark trades may hinder their capacity to monitor the market effectively.

The regulatory measures currently proposed to address these integrity and efficiency risks differ to a certain extent across countries. Appropriate coordination of these proposals is necessary at G20 level as well as evaluating their feasibility and potential impact on market efficiency and integrity:

- Circuit breakers, which are already widely used in EU exchanges and US futures markets and are being further tested in the US to curb risks related to algorithmic trading and HFT activities, seem fairly consensual in the market. Other proposals such as authorization of HFT players, regulating direct access to trade feeds, possible market making requirements, minimum tick sizes or measures to curb “quote stuffing” with a minimum order book resting period are more debated. Closer monitoring of HFT activity is also expected to encourage institutional investors to increase transparent trading. IOSCO and the FSB should give further global guidance on these issues in the report on technological developments due for June 2011. Some observers point out that the possible longer term impacts on market efficiency and investor / issuer confidence of developing technology and widespread computer-based trading strategies in major exchanges still need to be addressed.
- Short selling regulation was recently completed in the US with a circuit-breaker rule applicable to falls in share prices exceeding 10% compared to the previous closing price and principles have been put forward by IOSCO in order to strengthen the monitoring of these activities by regulators. Proposals have also been made by the EU Commission to complete and further harmonize existing national short selling regulations or temporary measures put in place during the financial crisis: ie flagging of orders as in the US, reporting to regulators and the market of net short positions exceeding certain thresholds and increase in the powers of supervisors. These proposals are currently being reviewed. A number of other countries are in the process of tightening their regulations.
- Different solutions are being explored to address the issues raised by dark trading: ie enforcing minimum thresholds for dark orders and limiting waivers, giving priority to transparent orders at equivalent price in a trading venue, improving the quality and speed of post-trade data publication, enhancing the regulation of BCNs...

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1. Which makes use of algo trading

2. Brokers operate their own dark pools referred to as Broker Crossing Networks (“BCNs”).

BCNs have been created by sell-side institutions who have enough “internal liquidity” to create an efficient matching engine by combining all their order flows.

3. Pre-trade transparency refers to the obligation to publish in real-time current orders and quotes ie prices for buying and selling interest

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Regulations adopted and implemented should be as consistent as possible internationally in order to facilitate cross-border activities, simplify their application by global and regional players in market organizations which have increasingly similar characteristics, increase their legitimacy and avoid creating regulatory arbitrage in activities which have a global dimension. This requires strong coordination by the FSB in relation with IOSCO and coordination among national market supervisors.

In order to face up to the major integrity and efficiency challenges posed by permanent innovation and technological development in capital markets, supervisors need to be able to continuously enhance their capacity to monitor markets. This requires investments to develop the appropriate technical and human resources needed to access and process market data and address evolving market abuse risks in particular. Political support is needed in this perspective. Industry players and regulators also need to work together within existing forums to find the right balance between innovation, stability and efficiency in cash markets that can best answer the needs of investors, issuers and market players.

The consequences for investors, issuers and supervisors of the increasing fragmentation and complexity of cash markets, following regulatory changes to foster competition, are also being looked at. The multiplication of trading venues has indeed resulted in increased choice, improved services and trading fee reductions but raises data consolidation, liquidity fragmentation and market monitoring challenges. In addition the magnitude of fee reductions for end-investors is questioned, given the investments required in connectiveness to multiple venues, the improvements still to come in the post-trading area, and the main focus of alternative venues on blue chip stocks, particularly in Europe. Solutions to mitigate the effects of trading fragmentation are currently being examined in the EU. They include building a 'consolidated tape' – for which different mandatory or industry-led scenarios are envisaged - and improving the quality and consistency of raw trade data.

