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CESR's CALL FOR EVIDENCE
Micro-structural issues of the European equity markets
Comments by AMAFI

1. **The Association française des marchés financiers (AMAFI)** has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

AMAFI has carefully examined the Call for Evidence on Microstructural Issues of the European Equity Markets, which CESR put out to consultation from 1 to 30 April (*CESR / 10-142*). The topic is certainly important, given how these microstructures have changed in less than two years. AMAFI drew attention to the most noteworthy of those changes when responding to the Call for Evidence on the Impact of MiFID on Secondary Market Functioning (*CESR / 08-872, AMAFI / 09-03*). The trends identified in that response are still at work.

2. In light of the foregoing, AMAFI wishes to submit a number of remarks for CESR's consideration. Unfortunately, however, the extremely short deadline has not left enough time to go into the level of detail warranted by the importance of the issues at stake.

Regrettably, Europe is not giving itself the means to address the issue of market microstructure with the necessary rigour

3. Following on from its Call for Evidence on the Impact of MiFID on Secondary Market Functioning, CESR published on 10 June 2009 a report titled Impact of MiFID on Equity Secondary Markets Functioning (*CESR / 09-355*). The report reviews the major changes that have taken place and identifies a number of related regulatory issues.

AMAFI finds it deeply regrettable that CESR took almost a year to publish a new Call for Evidence regarding developments that are admittedly becoming more pronounced but are certainly not new. The immediate consequence is a consultation period of just one month, which, because of the complexity of the questions raised, makes it highly unlikely that the responses will be of a high enough standard to provide constructive input. This is especially true for professional associations, which formulate their positions after a lengthy process of consultation with their members. In the case of AMAFI, this situation prevents us from holding truly productive discussions with our European counterparts, notably the members of the European Forum of Securities Association – EFSA (www.efsa-securities.eu). Yet this interaction is crucial to reaching a proper understanding of each member's particular problems and seeking the most appropriate ways of solving them.

4. Moreover the consultation period is so short, having regard to the deliberations and data-gathering efforts needed for the topics addressed by the Call for Evidence, that it is questionable whether the resulting contributions will be of genuine use to CESR.

The question is definitely worth posing because it is not specific to this consultation but goes much further. Not only have all CESR's deadlines become much shorter in recent months; but the lessons it appears to draw from its consultations seem less robust than before. Claiming that this state of affairs is justified because of the urgency prompted by the crisis is not a valid argument, as EFSA stressed in a letter to CESR in March 2010, in which it expressed its members' deep concern over this matter (*Letter to CESR*). Need it be pointed out that, on the very same issues, the US Securities and Exchange Commission (SEC) issued on 13 January a Concept Release on Equity Market Structure (*Release No. 34-61358; File No. S7-02-10*), allowing three full months for responses?

5. The question of whether the current consultation process is useful is especially relevant since one of the topics on which CESR is seeking information is high frequency trading (HFT) and its effects on market functioning. Juxtaposing data specific to a number of market participants is highly unlikely to produce the overall image that is vital for a detailed and precise analysis of the reasons behind the rapid development of HFT and the attendant consequences. Be that as it may, neither industry groups nor regulated markets (RMs) and multilateral trading facilities (MTFs) are in a position to contribute to this consolidated overview. On the one hand, it is not conceivable for industry groups to gather data that are highly strategic for their members. On the other hand, it may not be possible for RMs and MTFs to clearly identify data relating solely to HFT. And here, too, such data are strategic given the competitive environment in which these markets are operating.

If Europe seriously wants to analyse this question with the necessary rigour – and it would be a serious mistake not to do so – then a different approach is needed. AMAFI believes that an in-depth analysis of HFT is impossible unless CESR members reach agreement on an analytical methodology, the type of data to be collected, and how that information will be used. What is needed, therefore, is an approach similar to the one adopted recently by the SEC, which consists in imposing special reporting requirements on large traders in an effort to prevent market abuse more effectively but also to gather data useful for analysing market behaviours. It is vital that the European Securities and Markets Authority (ESMA) be given the necessary jurisdiction and powers for this purpose.

High frequency trading

6. That HFT has gained ground in Europe is a fact, although there are no precise data to measure its development, only estimates gleaned from different sources. It is also a fact that HFT has significantly altered the market structure and that one of the main reasons is that trading platforms need to attract HF traders for commercial reasons.

The developments resulting from the growth of HFT clearly have some positive aspects, such as innovation, greater liquidity[1] and narrower spreads. Conversely, questions are being asked increasingly frequently about matters such as:

[1] HF traders maintained a market presence, and thus contributed liquidity, even when the crisis was at its height.

- the economic interest of the execution speeds reached with HFT;
- the usefulness of the additional liquidity it brings;
- the impact on market transparency now that the reduction in average trade size on lit markets seems to be prompting institutional investors to rely more on dark pools or crossing networks.

7. These questions are important. They demand clear, well-argued answers so that the advantages and disadvantages of HFT can be gauged as precisely as possible. However, given the deadline imposed by CESR, AMAFI is unable to make an in-depth analysis of the elements at its disposal or, more importantly, of the way they interact. Besides, any such analysis would be flawed because collecting the necessary data would pose a strategic challenge to market participants involved in HFT.

It is therefore vital that CESR (or ESMA in future) should put itself in a position to gather HFT-specific data, which it can then use to analyse the positive and negative effects of this form of trading and determine whether it should be regulated and, if so, how. The first stage therefore consists in determining what characterises high frequency trading. One vital (but not necessarily sufficient) criterion in this regard is the use of co-location capacities on trading platforms (*see § 24 et seq*).

Question 1: Please describe trading strategies used by high frequency traders and provide examples of how they are implemented

8. AMAFI is not able to provide specific evidence on these strategies. The issues described by the SEC in its Concept Release are certainly relevant germane to the European market.

Question 2: Please provide evidence on the amount of European trading executed by HF traders (including the source(s) of that information). CESR is particularly interested in statistical material on: a) market share of HFT in orders/trades in Q1/2010 (and, if possible compared to 2008 and 2009), b) average trade size in Q1/2010 (and, if possible compared to 2008 and 2009), c) market participants, d) financial instruments traded (including cash vs. derivatives). If possible, please distinguish between HFT on transparent organised trading platforms and on dark pools of liquidity.

9. AMAFI is not able to supply precise data on these points. However, assuming that any data provided by respondents will be confidential, AMAFI believes that CESR (or ESMA in future) should publish a qualitative assessment of the overview obtained from the information as well as the general lessons to be learned from it.

Question 3: What are the key drivers of HFT, and (if any) limitations to the growth of HFT?

10. Three growth drivers are particularly noteworthy:

- technological progress, which increases transaction speeds both for trading systems and for market participants;
- the reduction in friction costs, which are due in particular to RMs' and MTFs' pricing policies.
- the multiplicity of trading platforms, potentially allowing for different prices on the same instrument.

One hindrance to the development of HFT is an increase in the number of players, which can curtail the gains generated by this activity whereas the expenditures needed to keep abreast of technological change may increase.

Question 4: In your view, what is the impact of high frequency trading on the market, particularly in relation to: market structure (eg. tick sizes); liquidity, turnover, bid-offer spreads, market depth; volatility and price formation; efficiency and orderliness of the market? Please provide evidence supporting your views on the impact of HFT on the market.

11. See § 6 and 7.

Lower volatility is often put forward as one of HFT's benefits. On this issue, an AMAFI member has published a study suggesting that the HFT has no impact − positive or negative − on intraday volatility.

On the question or orderliness, suffice it to say that in view of the development of HFT, the market authorities need to adopt supervisory tools appropriate to this type of activity.

Question 5: What are the key benefits from HFT? Do these benefits exist for all HFT trading strategies?

12. This question is directly related to the previous one. It assumes intimate and exhaustive knowledge of these strategies, which AMAFI does not have.

Question 6: Do you consider that HFT poses a risk to markets (eg. from an operational or systemic perspective)? In your view, are these risks adequately mitigated?

13. There is no evidence that HFT raises particular issues in terms of algorithmic trading, since execution speed does not appear to be a risk-increasing factor. In fact the operational or systemic risk associated with this activity may be low insofar as HFT strategies depend on the aggregation of small individual gains (or losses) and, in many cases, are such that market participants end the day with a flat position. However, given the considerable volumes now generated by HFT, a detailed analysis of this aspect assumes that it is possible to determine the maximum positions taken by market participants.

Question 7: Overall, do you consider HFT to be beneficial or detrimental to the markets? Please elaborate.

14. See § 6 and 7.

Question 8: How do you see HFT developing in Europe?

15. Considering the substantial resources being deployed by trading platforms worldwide effort to attract HF traders, this activity looks set to continue expanding.

This overall trend is unlikely to bypass Europe, for two reasons:

- integrating post-trade activities is an important factor in reducing friction costs;
- US firms specialised in HFT are currently setting up for business in Europe.

Question 9: **Do you consider that additional regulation may be desirable in relation to HF trading/ traders? If so, what kind of regulation would be suitable to address which risks?**

16. It is not reasonably possible to answer this question without a precise analysis of the consequences of HFT. The first step is therefore to gather the data needed for that analysis. See § 6 and 7.

Sponsored access

17. Sponsored access (SA) is a variant of direct market access (DMA), whereby a market member's clients are given access to the market trading platform with the same trading capacity as the member itself. Unlike DMA, however, SA assumes that the member does not screen its client's orders[2] for compliance with trading limits, market protection requirements, and other criteria.

AMAFI therefore finds CESR's line of questioning hard to understand. The legal relationship on which SA is based is necessarily one in which an investment firm presents its client's orders on a trading platform of which it is a member. Noting that the investment firm has no control over these orders does not change this basic fact. Given the framework in which investment firms operate, this legal relationship places them under a number of obligations in terms of prudential supervision, market protection (especially market abuse) and client protection.

18. Consequently, an investment firm that agrees to enter into an SA agreement as described above puts itself beyond the regulatory framework applicable to it. While some market participants certainly accept that risk because of mounting commercial pressures on their intermediation business, it is also true that no member-state regulator can tolerate such a situation. Therefore, if **SA were to become more widely used within investment firms' current operating framework, it would mean that some European regulators had not been performing their duties properly**.

If the intent of CESR's questions is to determine whether the operating framework ought to be modified so as to authorise SA, AMAFI refers it to the talking points produced for last year's IOSCO consultation on this issue (*AMAFI / 09-32*). We would stress, however, that the result of such a solution would be to eliminate any special prerogatives associated with membership of a trading platform. By virtue of the rules applicable to them, market members are a link in the chain that ensures secure and orderly markets, so it is hard to imagine pursuing that option. In any case, the entire legal framework applicable to market members would have to be redefined.

Question 1: **What are the benefits of SA arrangements for trading platforms, sponsoring firms, their clients and the wider market?**

19. See § 17 and 18.

[2] One of the main advantages is to reduce the latency that occurs when market members filter orders, even electronically.

Question 2: **What risks does SA pose for the orderly functioning of organised trading platforms? How could these risks be mitigated?**

20. See § 17 and 18.

Question 3: **What risks does SA pose for sponsoring firms? How should these risks be mitigated?**

21. See § 17 and 18.

Question 4: **Is there a need for additional regulatory requirements for sponsored access, for example: a. limitations on who can be a sponsoring firm; b. restrictions on clients that can use sponsored access; c. additional market monitoring requirements; d. pre-trade filters and controls on submitted orders.**

22. See § 17 and 18.

Question 5: **Are there other market wide implications resulting from the development of SA?**

23. See § 17 and 18.

Co-location

24. The development of co-location is directly linked to the growing importance of execution speed, particularly for HF traders. The physical proximity of members' execution servers to the platform's matching engines minimises latency by cutting the time needed to enter orders into the trading system and receive post-trade information.

Assuming that execution speed is a key criterion for some market participants, **offering co-location arrangements should definitely be approved because this would mean that participants have equal access to trading systems (for order transmission) and to market information (pre- and post-trade data).** This would prevent a participant from gaining an advantage simply by locating its execution servers in closest proximity to the market's matching engines, thus achieving the shortest connection with the fewest relays and hence the fastest execution. **If co-location is allowed, then the regulator's role should be to ensure it is accessible to any and all participants** and that access is transparent and non-discriminatory. In particular, connection arrangements must be the same for all participants, as must the length of the cable between the server hosting the co-location service and the market's server.

25. However, the co-location issue also raises the question of equal access to trading platforms. Acknowledging the need for equal access to co-location services is tantamount to admitting that participants who do not use them will be at a competitive disadvantage.

Equal access to trading platforms is a multifaceted and therefore highly complex issue. In view of the deadline imposed by CESR for this consultation, AMAFI has been unable to analyse the question in depth and produce a useful digest. That said, three questions warrant special attention:

- If all market participants have access to a co-location service, would competition be distorted simply because some of them choose not to avail themselves of it?
- Should technological advances be restricted simply because not all players are able to benefit from them at the same pace?
- Does not the development of co-location introduce a discriminatory element that could penalise market participants depending on whether or not they are able to take full advantage of this opportunity[3]?

26. Broadly, the issue of co-location is closely linked to that of HFT but also algorithmic trading. Aside from ensuring equal access to co-location, the question of how it is treated will therefore depend heavily on the findings of the analysis of HFT and algorithmic trading.

Question 1: What are the benefits of co-location services for organised trading platforms, trading participants and clients/investors?

27. See § 24 - 26.

Question 2: Are there any downsides arising from the provision of co-location services? If yes, please describe them.

28. See § 24 - 26.

Question 3: What impact do co-location services have on trading platforms, participants, and the wider market?

29. See § 24 - 26.

Question 5: Does the latency benefit for firms using co-location services create any issues for the fairness and efficiency of markets?

30. See § 24 - 26.

Question 5: In your view, do co-location services create an issue with the MiFID obligations on trading platforms to provide for fair access?

31. See § 24 - 26.

[3] For example co-location does not seem to have the same advantages for all market participants subject to best execution rules. Since they have to take their execution decisions on the basis of data sourced from several trading platforms, they are required under any circumstances to "channel" information to a central server. It should be noted, however, that all HFT strategies based on arbitraging between trading venues are subject to those information channelling requirements.

Question 6: **Do you see a need for regulatory action regarding any participants involved in co-location, i.e. firms using this service, markets providing the service and IT providers? Please elaborate.**

32. See § 24 - 26.

Fee structure

33. Trading platforms' fee structures raise important questions, particularly since they have changed significantly in recent months due to the arrival of MTFs.

In view of CESR's tight deadline, AMAFI has not been able to assemble the elements needed for a pertinent analysis. However, it wonders what CESR really expects from this section of its Call for Evidence:

- First, CESR is unlikely to get a comprehensive picture of the situation from the data supplied by individual respondents;
- Second, the usefulness of this methodology is questionable, since each CESR member can easily obtain the requisite data from the platforms it supervises.

34. In any case the question of how price schedules affect market organisation is not new. The principle of discounts for business volume has long been in place on most platforms and is almost certainly one of the factors that has contributed to the concentration of trading flows and hence a reduction in the number of members, with the attendant side-effects.

There is no evidence at present to show that the latest trends in fee structures have radically altered the situation. Agency brokers are subject to precise rules that prevent them from taking this dimension into account unless it is in the client's interest. With regard to proprietary traders, fee structure is one of the aspects of inter-platform competition that is to be reinforced by collective agreement. The principle of fee transparency is certainly appealing in order to avoid discriminatory pricing. Be that as it may**, the issue of fee structure can be dealt with only as part of an overall review of market structure and the resources needed to steer it in the right direction.**

Question 1 **Please describe the key developments in fee structures used by trading platforms in Europe.**

35. See § 33 and 34.

The key developments of recent months have been marked by a steep fall in the prices charged by trading and clearing platforms. This is a response to insistent demand from users that certainly would not have been satisfied to the same extent if platforms had not been competing intensely with one another.

It is also true that not all investors have benefited from the price reductions, because intermediaries need to make substantial investments in their execution tools in order to cope with liquidity being fragmented among platforms.

Question 2 **What are the benefits of any fee structures that you are aware of?**

36. See § 33 and 34.

Question 3 **Are there any downsides to current fee structures and the maker/taker fee structure in particular? If yes, please describe them.**

37. See § 33 and 34.

Question 4 **What are the impacts of current fee structures on trading platforms, participants, their trading strategies and the wider market and its efficiency?**

38. See § 33 and 34.

Question 5 **How important is the fee structure of a trading platform in determining whether to connect or not to it for trading. Please elaborate.**

39. See § 33 and 34.

Question 6: **Do you consider that the fee structures of trading platforms should be made public to all market participants? Please provide a rationale for your answer.**

40. See § 33 and 34.

41. The scope of "market participants" needs to be clarified.

If the term applies to members of RMs and MTFs, it should be remembered that, under MiFID, they benefit from non-discretionary access, meaning that if two members are in the same situation they must benefit from the same pricing structure and therefore be aware of the underlying principles.

But if the term applies to all market players, including issuers and investors, then making the information public may not necessarily be useful to them.

Question 7: **Is there a role for regulators to play in the fee structures? If yes, please describe it.**

42. See § 33 and 34.

Tick size

43. The question of tick size is an important one, with two key dimensions:

- determining whether a security should have different tick sizes depending on the platform on which it is traded;
- determining the optimal tick size for a particular security.

44. The possibility of finding different tick sizes on different platforms may have been an issue in the early months of the post-MiFID era but this is no longer the case, since RMs have reached an agreement with the main MTFs under the auspices of the Federation of European Securities Exchanges (FESE).

If the debate were to re-open, European regulators acting through CESR (ESMA in future) could usefully step in to set tick sizes in collaboration with the markets and their participants.

45. The issue of optimal size is more important than that of single size. The FESE-brokered agreement was most probably reached because optimisation did not consist solely in reducing the price increment, and also because the platforms realised that competing on this aspect would be fruitless. Much has been written about this issue, with varying conclusions. One area of agreement, however, is that if the bid-ask spreads quoted for a security are too wide relative to its liquidity, then that liquidity is likely to go elsewhere; if they are too narrow, they make the market much harder to read.

Optimising tick sizes requires careful management, based on a wide variety of factors such as liquidity and volatility, and has to be performed on an ongoing basis. In theory, because of the resources needed, trading platform operators would be best placed to handle this real-time management. Regulatory involvement would be necessary only if the markets experience practical difficulties in the management process[4], notably adjusting a single tick for a particular share[5]. In any case, the regulator (in principle CESR, or ESMA in future) should only become involved in this matter if it has the resources needed to do so

Question 1: **In your view, what has been the impact of smaller tick sizes for equities in Europe on the bid-ask spreads, liquidity, market depth and volatility of these markets? Are there any spill-over effects on derivatives markets?**

46. See § 43 - 45.

Question 2: **What are the benefits/downsides of smaller tick size regimes for shares in Europe?**

47. See § 43 - 45.

Question 3: **Is there a need for greater harmonisation of tick size regimes across Europe? Please elaborate.**

48. See § 43 - 45.

Question 4: **Is there a role for regulators to play in the standardisation of tick size regimes or should this be left to market forces?**

49. See § 43 - 45.

[4] However, they might also intervene if adjusting tick sizes were admitted as an effective way of slowing the advance of HFT in certain situations.

[5] It could be agreed, for example, that the tick size to be adopted by all trading platforms should be set by the most relevant market for each stock.

Question 5: Have organised markets developed an appropriate approach to tick sizes?

50. See § 43 - 45.

Question 6: Should regulators monitor compliance with the self-regulatory initiative of the MTFs and FESE? If this initiative fails, do you see a need for regulators to intervene?

51. See § 43 - 45.

Question 7: What principles should determine optimal tick sizes?

52. See § 43 - 45.

Indications of Interest (IOIs)

53. The question of IOIs is actually part of the broader issue of ensuring that market participants and their clients have an equal opportunity to effect the underlying transaction. Is it normal that, via an IOI, this opportunity should be available only to a limited number of participants rather than to all those who may be interested in it?

The question is certainly vital but it cannot be approached from this angle. If so, it would be necessary to address the much wider question of whether any order should be accessible to the entire market as a matter of principle. This is tantamount to asking whether it is healthy to allow such transactions to be executed outside a trading platform; and even if it is healthy, whether several platforms should be able to trade a stock simultaneously. When an intermediary executes a trade off-platform, it is certainly not going to question all existing counterparties but only those it considers most appropriate. Likewise when an intermediary chooses one platform over another, only the counterparties on that platform actually have access to the trade.

54. It is unlikely that the aim of the debate is to overturn the competition-based approach, which would involve a fundamental challenge to the policies adopted since the release of the Financial Services Action Plan. So the only issue to determine is whether pre-trade transparency rules are being complied with.

There is accordingly no need to question the principle of IOIs. Provided they do not represent a commitment to trade by the party that issues them, IOIs are:

- a classic tool for market participants because they were developed long before MiFID and are merely a technologically advanced form of telephone call;
- particularly important for allowing an intermediary to manage clients' orders in their best interests, in particular by eliciting block trading opportunities without disclosing the positions it is managing, which would be counterproductive.

In practice, therefore, the basic issue is to determine whether IOIs are expressed simply to flout the applicable transparency rules, and therefore whether the intermediary actually intends to trade in exactly the same way as it would with an order. From this standpoint, IOIs that include all the elements needed to carry out a transaction on this basis are therefore open to criticism.

Question 1: Please provide further information on how IOIs are currently used in European markets by investment firms, MTFs and RMs?

55. See § 53 and 54.

Question 2: Which are the key benefits/downsides of such IOIs? Please provide evidence to support your views.

56. See § 53 and 54.

Question 3: Do you consider that MiFID should be amended to clarify that actionable IOIs should be subject to pre-trade transparency requirements?

57. See § 53 and 54.

Question 4: Do you see circumstances where it would be appropriate for IOIs to be provided to a selected group of market participants? Please provide evidence/examples to support your views.

58. See § 53 and 54.