

## Dangerous Opacity

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Last week I blogged about the impact of electronic market making on lit books, concluding that whilst it has been positive, institutional investors sometimes need alternatives which allow trading with less market impact. We also believe in the power of competition to drive innovation, reduce costs, and make our industry more efficient.

Apparently, one of our largest competitors has reached a different conclusion.

Executives of NYSE Euronext have argued that competition has driven over-fragmentation<sup>1</sup>, that established markets should not be able to use maker-taker pricing<sup>2</sup>, and that alternatives to lit books are 'not legitimate' and are causing 'dangerous opacity' that will undermine price formation and confidence in our markets<sup>1</sup>. What is motivating these arguments?

### **Does NYSE Euronext really believe that fragmentation can go or has gone too far?**

- One feature of US markets that really interests me is that most market operators operate multiple order books with differing tariff structures – fragmenting their own market so as to address different customer segments. NYSE was amongst the first to do so; it operates its hybrid electronic/human Classic (floor) market and also the fully electronic NYSE Arca – and does not seem about to merge them together. So they apparently have no problem with contributing to fragmentation in the US.
- My opinion is that European investors, brokers, market operators and regulators are not yet fully accustomed to competition and fragmentation. But, having worked in New York when ECNs first proliferated, I'm not worried. It will take some time, but wider adoption of Smart Routing, more efficient clearing arrangements, further standardisation of tick sizes and volatility interruptions, and consolidation amongst venues will make today's concerns about fragmentation seem quaint.

### **Does NYSE Euronext really believe that use of maker-taker tariff models by established venues distorts the market?**

- Apparently not - NYSE Arca in the US operates maker-taker pricing, and has done for years. As for Europe, it's difficult to comment, since details of the exact pricing incentives available to 'liquidity providers' are not readily available on their [website](#).

### **And does NYSE Euronext really believe that everything except block trading should be completely transparent so as to avoid 'dangerous opacity'?**

- It doesn't seem so to a casual observer. The NYSE Classic market (the 'floor') in particular stands out for having an unusually opaque model. By according them what they refer to as "*parity*", certain members get to jump the queue completely;
  - Orders from Designated Market Makers (rebranded 'specialists') get *parity* with other participants' orders. This means that if there are 5,000 shares on the bid from a number of 'normal' members, and the DMM subsequently bids for 500 shares, the first 1,000 shares of an incoming sell order will be split 50/50 between the DMM and

the other queued limit orders. DMM's get this privilege as compensation for their obligations to maintain a "fair and orderly" market – though given the amount of money DMM privileges change hands for, *parity* clearly has significant economic value.

- Similarly, each *individual* 'Trading Floor Broker' also gets *parity* with normal members and with DMMs, and can jump the queue without even needing to display their orders publically. They also get unique visibility of, and access to, market-depth data that is not visible to normal members. I'm not sure they have any obligations, but giving parity to floor brokers allows them to attract order flow and hence ensures that the floor looks like a hive of activity on television.
- Personally, I don't like it when people cut in front of me in a queue, and given a choice, I wouldn't choose to stand in a queue if it was specifically designed to work that way – although I welcome the fact that participants are offered the choice. But, in my mind, NYSE Euronext's commitment to this model does rather undermine their argument that all non-block trading should be fully pre-trade transparent to avoid 'dangerous opacity'.

A lot is at stake in the MiFID review – and the debate is especially heated around the topic of non-displayed trading – both in MTF Midpoint Books, and Broker Crossing/Internalisation Systems. The exchanges that pre-MiFID enjoyed the protection of "concentration rules" are struggling to come to terms with a landscape in which they face competition – both from market operators and (to some extent) from their clients. So they try to persuade politicians, regulators and the general public that we're approaching a precipice and need to turn back, arguing that whilst MiFID was intended to unleash competition and choice for market participants, the exchanges were supposed to win.

At Turquoise we believe that;

- Transparent price-time markets are not ideal for every order. There is a legitimate market need for alternatives to lit orders books.
- Competition is somewhat distorted and price formation potentially affected by inconsistencies in the rules applicable to MTF and broker-operated non-display facilities. But, rather than trying reduce choice for investors, a better solution would be improved post-trade transparency (to avert worries about price formation) and a relaxation of the waivers that limit innovation (and thus competitiveness relative to broker crossing systems) of Regulated Markets and MTF-operated non-display venues.
- Concentration rules were eliminated because they had proven to be a barrier to competition and innovation. Brokers now have greater flexibility to internalise, and whilst *in theory* that could ultimately lead to lower volumes or wider spreads in public limit order books, there is no evidence to suggest either US or European markets are close to such a scenario *in reality*.

We invite feedback from brokers, competitors, regulators and institutional investors on our approach and our views.

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