

Lots of Cooks...

November 22nd 2010

IOSCO (the International Organization of Securities Commissions) recently published a Consultation Report titled “Issues Raised by Dark Liquidity”. And the ECON Committee of the European Parliament voted on 9 November to adopt a report intended to influence the MiFID review, with an emphasis on encouraging the use of pre-trade transparent venues. So how similar were the recommendations?

IOSCO’s headline recommendations from its press release were rather mundane, reflecting existing best practice rather than suggesting any radically new ideas. But reading between the lines...

“Principle 3: In those jurisdictions where dark trading is generally permitted, regulators should take steps to support the use of transparent orders rather than dark orders executed on transparent markets or orders submitted into dark pools. Transparent orders should have priority over dark orders at the same price within a trading venue.”

Not too exciting really, given that most exchanges, MTFs, and ECNs already apply price-visibility-time priority. So why state the obvious, and what didn’t they say?

First, the US practice of Flash Orders (which the SEC proposes to ban) probably contravene these guidelines, especially where marketable orders are reflected to preferred liquidity partners (whose liquidity is “dark”) prior to interacting with lit bids or offers in the venue’s book.

Second, the report goes on to emphasise that rather than restrict dark orders per se, regulators should instead *“look at ways to incentivize market participants within the regulatory framework to use transparent orders... the key interest is in taking steps to ensure that there are adequate transparent orders in the marketplace.”*

- In Europe, MiFID sought to promote transparency by banning most hidden and discretionary orders in lit books. However, rather than encourage the use of transparent order types as anticipated, this tougher stance spawned the creation of discrete dark books (both MTF and broker-operated) which are isolated from the lit orders books. The effect has been to demote transparent books in the order routing hierarchy for certain types of flow.
- If European regulators were to take IOSCO’s recommendations to heart, they might instead consider encouraging more flexible use of dark orders within transparent order books (e.g. relaxing the LIS constraint), so as to encourage participants who want to post dark orders to use these venues. After all, lit books offer far greater certainty of execution, and so would be very attractive for smaller hidden orders.
- Unfortunately, the political tide seems to be flowing in the other direction, with the ECON Committee contemplating whether further restrictions to dark order types and venues would *“encourage”* liquidity into lit venues. Personally, I doubt that “forcing” such orders to be displayed will produce the desired outcome. Lit markets have evolved, and put simply, they are just too transparent and too efficient for some investors/orders – with prices changing more quickly than ever to reflect slight imbalances between supply and demand. So I worry that further restrictions will drive liquidity out of the markets altogether.

Third, giving transparent orders priority over dark orders *within each venue* can only be expected to have a beneficial impact if much of the dark liquidity is in venues that also have transparent orders. With most of the dark liquidity residing in discrete dark MTFs or BCNs, this prescription lacks impact. Both the SEC and Canadian IROC have considered going further, giving transparent orders priority vs. dark orders at the same price *across markets*, e.g. by requiring that dark pool executions always offer both participants material price improvement (e.g. at least one tick) vs. the best available lit price for equivalent size.

Turning to the ECON Committee report, it's clear that it is a product of negotiation & compromise, and an attempt to square the many competing vested interests. The general thrust is that since MiFID introduced competition, the pace of innovation has outstripped the ability of regulators to keep up, and also that competition has produced some unexpected or unwelcome outcomes (including the emergence of non-display MTFs and broker crossing networks). The final report avoids some of the more over-protective prescriptions that had been in circulation previously, and which would have harmed market quality, for which the committee should be commended. But even in this compromise document, there were a few recitals/recommendations that caught my eye:

- *“Whereas market fragmentation in equities trading has had an undesired impact upon liquidity and market efficiency... “*

I think a more positive view of MiFID is warranted, because although many participants are still adjusting to the new landscape, spreads and liquidity depth are demonstrably superior in stocks that are subject to competitive trading (thankfully Spain's failure to implement MiFID properly creates a useful control group), and given that trading tariffs are some 90% lower than they were pre-MiFID.

- *“Asks for an investigation by the Commission into the effects of setting a minimum order size for all dark transactions, and if it could be rigorously enforced so as to maintain adequate flow of trade through the lit venues in the interests of price discovery;”*

The target here is both MTF/Exchange dark pools and broker crossing networks. But what's missing is any discussion as to what is meant by *“adequate”*. Certainly, there is no sign that price formation has been in any way weakened thus far, and economic theory suggests that price formation is much more robust than regulators/politicians are giving credit for. Personally, I have more sympathy for the SEC's emphasis on *“avoiding a two tier market”* as a rationale for ensuring the pre-eminence of venues with non-discriminatory access. Again, I believe it would be better for market efficiency and liquidity if regulators allowed small dark transactions to be handled by lit venues, rather than see them ban such order types altogether.

- *Suggests ESMA conduct a study of the maker/taker fee model to determine whether any recipient of the more favourable “maker” fee structure should also be subject to formal market maker obligations and supervision;*

To me, this suggests a limited understanding of the topic and of market structure. Firstly, MTFs treat all members equally – and hence all MTF members (basically every major bank or brokerage house in Europe) are receiving the *“maker”* rebates for a proportion of their business. Secondly, and related to the point of equal treatment, most European markets no longer have a concept of market makers with particular privileges and obligations for liquid

stocks. And thirdly, some MTFs pay rebates for passive liquidity, whilst others pay rebates for aggressive flow, making receipt of rebates a poor basis to define “market making”.

- *“Requests that no unregulated market participant be able to gain direct or unfiltered sponsored access to formal trading venues and that significant market participants trading on their own account be required to register with the regulator...”*

Many proprietary trading firms have been told by their domestic competent authorities that their activities are not subject to regulation, so this would be a significant change.

- *“Calls for an investigation into whether to regulate firms that pursue HFT strategies to ensure that they have robust systems and controls... and the ability to demonstrate that they have strong management procedures in place for abnormal events”*

Clearly, HFT firms are risk management specialists (people trading with their own money and seeking to capture low-alpha opportunities have a healthy appreciation for risk), and faced with failings of market infrastructure/regulation during the US flash crash, they behaved appropriately by stopping trading. Perhaps regulators would have preferred them to “stand in front of the train”, and keep buying the face of a tsunami of sell orders – but that would simply convert a brief liquidity shock (albeit with nasty implications for consumer confidence in the integrity of markets) into a more serious systematic-risk issue that could have bankrupt firms and/or their clearing brokers.

- *“Asks for an investigation into OTC trading of equities and calls for improvements to the way in which OTC trading is regulated with a view to ensuring the use of RMs and MTFs in the execution of orders on a multilateral basis and of SIs in the execution of orders on a bilateral basis increases, and that the proportion of equities trading carried out OTC declines substantially”*

This is actually one of several recitals explicitly calling for a reduction OTC trading in favour of transparent exchanges and MTFs. Still, the suggestion that *“improvements to the way in which OTC trading is regulated”* should lead to less OTC trading seems somewhat odd.

Even though some of the Committee’s recommendations might benefit MTFs such as Turquoise at the expense of OTC, I’m troubled by assertions/conclusions that contradict the empirical evidence and by the emphasis on “protecting” lit markets by restricting innovation and investor/intermediary choice, rather than by allowing them the flexibility to compete.

Hopefully CESR/ESMA will find a way to address the Committee’s concerns whilst recognising that MiFID is actually working, and that much of the anxiety over fragmentation and “opacity” can be attributed to growing pains that will subside as participants become accustomed to the new market structure.

As for unintended consequences, I’m willing to bet that these efforts to drive trading towards transparent venues will lead to a further proliferation of non-display MTFs. Any takers?