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Committee of European Securities
Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

Paris, 29 April 2010

AFG RESPONSE TO CESR'S CALL FOR EVIDENCE ON MICRO-STRUCTURAL ISSUES OF THE EUROPEAN EQUITY MARKETS

Ref.: CESR/ 10-142

Dear all,

The Association Française de la Gestion financière (AFG)[1] welcomes CESR's call for evidence on Micro-structural issues of the European equity markets. In the light of equity markets' recent changes and global rise in HF[2] trading, we clearly support CESR's need to gain in this field's understanding.

General comments

The nature of the subject is fairly complex and fast-moving. Technological advances in electronic trading towards lower latency make up a constitutive and undeniable feature of a reshaped equity markets' architecture and do not constitute an abusive market practice per se.

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

[2] HF : high frequency

This is not to commingle with some market behaviours that developed in the same time but went too far, underlying disrespect of market fairness and equal treatment and that are, as such, to be banned ("flash orders", "naked sponsored access"). Distinction is to be made between innovative trading and seizing unfair advantage.

HF trading represents a growing share of the daily volume of stocks' trading (about 70% in US markets and 25% currently in Europe, probably 30% by the end of the year and 45% by 2012[3]). Therefore, deeper knowledge on the subject is of paramount importance for regulators to assist them in their mission to maintain effective regulation and credibility but also to avoid unintended regulatory consequences.

Market participants advocate that the majority of HF trading volume relates to execution of client orders in the market and proportioning liquidity to participants (market maker and algo trading)[4], some volume relates to short-term bets or arbitrage. Arbitrage HFT strategies are low capacity strategies structurally dependent on the type of market conditions.

Our members, as the other market participants in general, are divided on their HFT's market impact assessments, but they agree that, as of today, there is clearly not enough hard data and backed analysis at hand. It is therefore difficult to assess and state with a high degree of confidence what the resulting effects are. Deciding between positive and negative views is a delicate exercise at this stage. We suggest commissioning an academic study and gathering reliable exhaustive data to better grasp effects of HFT in European equity markets.

Some of our members advance arguments that support positive effects, such as:

- increased liquidity and market depth
- tighter bid-ask spreads and diminished costs for the average investor
- better price formation process

Some others, on the contrary, argue in favour of negative outcomes, such as:

- worsened conditions (in volatility and price) for block trading, even when the block is split into tinier trades on several markets as algorithms notice by placing hundreds of orders and immediately cancelling them
- heavier bandwidth usage
- higher de-correlation from fundamentals and globally from "real economy" as strategies fixated on short term trading profits represent an increasing part of the market

Our view on "Flash Orders":

- Flash orders occur when some exchanges hold orders for a split-second before publishing them on competing platforms, thus enabling a part of market users with privileged access; whereas exchanges should ensure every user gets trading data at the same time, with the same priority and at the same level of access. These "pre-routing orders" are compared to front running and should be banned.

Our view "Naked sponsored access"

[3] Source : AITE group

[4] A large share of the trading today considered as HFT relates to more efficient implementation of old trading styles using more efficient technology. Contemporary forms of trading must be captured by the regulation in the same way as the old ones.

- “Naked sponsored access”[5] or “unfiltered access” is the practice of a non-broker-dealer client using the exchange membership of a broker-dealer without any pre-trade validations. It involves brokers not screening orders en route for markets. It means that there are no risk controls and no operational supervision on a pre-trade basis. Order entry errors may occur and may be of consequence especially for a high volume at a high speed. Naked sponsored access should be banned and broker-dealers should implement risk controls and supervisory procedures to manage risks on a pre-trade basis for every participant entering the market. Our members believe all access to markets should go through a risk filter maintained by the sponsoring broker for real time monitoring of trading volumes, trading size and open positions, with as much redundancy as possible.

Therefore, AFG urges for access and risk control level playing field across all market participants.

Some voices rise to require limiting IOIs as seen as unfair advantages.

Another domain requiring a closer look concerns the volume of order cancellations. While potentially enhancing liquidity (by affording automated traders greater flexibility when posting quotes), a too high volume of cancellations may be indicative of their usage as feints to test the market. Massive cancellation might affect negatively the price discovery process.

Our view on co-location and fee structure

- The rules for accessing co-location should be equitable. Our members believe regulators should ensure that all market participants have access to co-location services on equal terms and that this does not become a closed member club. Limited space for co-location and monopoly pricing may be an issue.
- AFG members require transparency and democratic access to different fee structures. Indeed, fee structures should be public and if possible any rebates should be available to any market participant who conforms to a particular trading style. It will be difficult for participants to comply with MiFID if the cost structure of certain venues in not public.

Our view on tick size

- Smaller tick sizes generally tend to decrease the bid-ask spread. However, the average market spread seems to be proportional to the volatility per trade (Matthieu Wyart; Jean-Philippe Bouchaud; Julien Kockelkoren; Marc Potters; Michele Vettorazzo, "Relation between bid-ask spread, impact and volatility in order-driven markets", Quantitative Finance, 8 (1), 41-57 (2008)).
- In our members view, as a general principle for the size of the tick, the average spread should be more than 1 tick. But the tick should not be too small either because this would lead to many order submissions inside the spread without trades. Similarly a very low tick size leads to a fragmentation of liquidity between many prices. In certain markets it can be shown that also in markets with low tick sizes, liquidity tends to accumulate to certain “key” price levels. There is thus a balance between tick size and optimal spread for a security. There could be a rationale for a regulation setting maximum tick sizes depending on the price of a financial instrument. Ie the tick size should be smaller for an instrument quoted at one euro as opposed to euro100. Dually listed stocks should have the same tick sizes on different exchanges.

[5] AITE group indicates 38% naked access on markets’ average daily volume compared to 9% 4 years ago

- The standardisation of tick size regimes is an area where the regulatory authorities could improve market structure by harmonizing practices. Our members think the benefits of such harmonization would clearly outweigh the costs.
- In order to determine optimal tick size, academic research and numerical simulations of artificial markets need to be done in order to ascertain such principles.

AFG considers that such a complex topic requires a more lengthy consultation period. We may make additional comments onward.

If you need any further information, please don't hesitate to contact myself at +33 1 44 94 94 29 (p.bollon@afg.asso.fr) or Eric Pagniez, at +33 1 44 94 94 06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33 1 44 94 94 31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon