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*Committee on Economic and Monetary Affairs*

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# DRAFT REPORT

on Regulation of trading in financial instruments - "dark pools" etc.  
(2010/2075(INI))

Committee on Economic and Monetary Affairs

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## MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

### on Regulation of trading in financial instruments - "dark pools" etc. (2010/2075(INI))

*The European Parliament,*

- having regard to the Directive 2004/39/EC on markets in financial instruments (MiFID),
  - having regard to Directive 2003/6/EC on insider dealing and market manipulation (market abuse),
  - having regard to the G20 declarations of 2 April 2009 in London, of 25 September 2009 in Pittsburgh, of 26 and 27 June 2010 in Toronto;
  - having regard to the CESR technical advice to the European Commission in the context of the MiFID Review - Equity Markets (Ref.: CESR/10-394),
  - having regard to the CESR technical advice to the European Commission in the context of the MiFID review –Transaction Reporting (Ref.: CESR/10-292),
  - having regard to the CESR technical advice to the European Commission in the context of the MiFID review –Investor Protection and Intermediaries (Ref.: CESR/10-417),
  - having regard to the CESR call for evidence on micro-structural issues of the European equity markets (Ref.: CESR/10-142),
  - having regard to the Report to the French Minister of Economy, Industry and Employment on the revision of the MiFID from February 2010,
  - having regard to the IOSCO consultation report on "Policies on direct electronic access" of February 2009,
  - having regard to the CPSS and IOSCO recommendations for central counterparties of November 2004,
  - having regard to the Concept release Securities and Exchanges Commission on Equity Market Structure (No. 34-61358; File No. S7-02-10),
  - having regard to Rule 48 of its Rules of Procedure,
  - having regard to the report of the Committee on Economic and Monetary Affairs (A7-0000/2010),
- A. whereas the G20 set out that no financial institution, no financial product and no territory should remain outside the scope of intelligent regulation and effective supervision,
- B. whereas consumer protection and competition on a level playing field were the key objectives when MiFID came into force; following the financial crisis, limiting systemic risk must be prioritised,

- C. whereas market fragmentation has had an inevitable impact upon liquidity and market efficiency, the effect of an increased number of venues and increasingly technology driven trading has significantly decreased average order execution size from €2,266 in 2006 to €923 in 2009,
- D. whereas the decrease in order size has led to a reduction in the capacity of market participants to instantly execute large orders on a particular market and has encouraged the expansion of dark pool trading; although less than 10% of all trading in EEA equities shares on organised markets use the MiFID pre-trade transparency waivers (CESR/10-394),
- E. whereas Broker Crossing Networks (BCNs) provide different services to Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs) in so far as they are closed systems and a technological extension of the traditional, discretionary broker-client relationship,
- F. whereas the challenge involves keeping the benefits of competition in terms of more competitive and innovative trading infrastructure whilst ensuring quality and integrity for all participants' in a more fragmented market,
- G. whereas the risks associated with electronic order systems and the significant share of trading volumes attributable to HFT strategies, estimated at 30-50 %, were manifest in the US "flash crash" on May 6th when HFT liquidity providers exited the market,
- H. whereas greater transparency via pre and post trade reporting of trading activity across all asset classes provides improved early warning of the build up and scale of developing problems,

### **MIFID Trading Venues**

1. Calls upon the Commission to secure the necessary strengthening of market infrastructure across all trading venues and clearing systems to enable them to cope with future risk through enhanced transparency, improved resilience and regulatory oversight of all aggregated trades;
2. Suggests that, in the interests of equitable treatment, rules need to be introduced such that MTFs transacting either a similar volume of trades or having a similar market impact to a RM (subject to a threshold) are subject to the same level of supervision and therefore regulated in a comparable way;
3. Asks for an investigation into the functioning of the Systematic Internaliser (SI) regime and the bringing forward of improvements to the way in which this category is regulated to increase its use as a subset of OTC;
4. Demands that investment firms which provide the service of portfolio management must be provided with best execution by the investment firms with whom they place orders notwithstanding that the portfolio manager is categorized by MiFID as an eligible counterparty;

5. Calls for a review of whether order-by-order best execution needs to be better served by regulation in relation to the availability of data, both post-trade and in relation to execution quality, and in relation to market technology, such as order routers and venue connections;
6. Calls for the introduction of new provisions in MIFID for BCNs including requirements to submit to the competent authorities:
  - a) a description of the system, ownership and clients
  - b) details on access to the system
  - c) orders matched in the system
  - d) trading methodologies and broker discretion
  - e) arrangements for immediate post trade reporting;
7. Calls for an investigation into a suitable volume threshold above which BCNs would be required to convert to an MTF;
8. Seeks a sectoral consultation which will inform the Commission on whether market makers should be allowed to interact with dark pool orders within a BCN, or whether it should be disallowed and remain a venue for buy side customer orders to cross;
9. Suggests that a minimum order size for dark pool transactions, whether on an organised trading venue or BCN, may be warranted and asks for an investigation into the merits of this for maintaining adequate flow of trade through the lit venues in the interests of price discovery;

### **Pre-Trade Transparency Waivers**

10. Calls for a review of the existing MiFID pre-trade transparency waivers to:
  - a) Reduce the threshold of the Large in Size waiver in recognition of reduced trade size
  - b) Consider whether a suitable minimum threshold should be introduced for the Reference Price waiver to encourage the use of lit venues
  - c) Broaden the Reference Price waiver to include trades that fall within the current spread in the reference market
11. Asks for a more uniform application of the pre-trade waivers across Member States to limit implementing differences that can lead to uncertainty, regulatory arbitrage and an unlevel playing field; suggests that technical standards could be an appropriate way of achieving this, in keeping with the concept of a single rule book for financial services

### **Consolidated Tape**

12. Calls on the Commission to establish a working group to overcome the barriers to a European Consolidated Tape; and establish a privately run system that does not place any further financial burdens on tax payers to a Commission defined deadline
13. Calls upon CESR to draw up common reporting standards and formats for the reporting of

post trade data to aid in data consolidation

14. Asks that all reporting venues are required to unbundle data so information can be made available to all market participants at an affordable and comparable cost; further, asks the Commission to consider limiting the number of venues that trades can be reported to so further fragmentation can be avoided
15. Calls for a reduction in the time limit for deferred publication so transactions are reported within twenty four hours of taking place; with regards to electronic transactions, in ordinary circumstances, delays of more than 1 minute should be considered unacceptable

### **Micro-structural issues**

16. Insists that post the 'Flash Crash', all trading platforms stress-test their technology and surveillance systems to ensure that they could successfully deal with the activity associated with HFT and algorithmic trading in extreme circumstances
17. Calls for an examination of the costs and benefits of HFT on markets and its impact upon other market users, particularly institutional investors, to determine whether the significant market flow generated automatically is providing real liquidity to the market and what affect this has on overall price discovery
18. Calls for the regulation of firms that pursue HFT strategies to ensure that they have robust systems and controls with ongoing regulatory reviews of the algorithms they use and the need to demonstrate that they have strong management procedures in place for abnormal events
19. Calls for all trading venues allowing co-location of servers, whether directly or through third party data providers, to ensure that equal access for all co-located clients is maintained and where possible under the same infrastructure latency arrangements to comply with non-discriminatory practice outlined in MiFID
20. Calls upon regulators to monitor and regulate the provision of sponsored access and to consider additional measures including:
  - a) expressly prohibiting unfiltered sponsored access to companies that do not belong to the same corporate group as the sponsor
  - b) requiring broker-dealers to establish, document and maintain a system of risk management controls, pre and post trade, and supervisory procedures to manage the financial, regulatory and other risks related to its market access
21. Calls upon the Commission to adopt the principles being developed by the Technical Committee of IOSCO on direct electronic access, including sponsored access, which will cover the criteria for selecting clients who can be given sponsored access; the contractual relationship between the platform, the member, and the client and outline their respective responsibilities regarding their usage with suitable controls and filters
22. In order to comply with the principle that all investors should be treated equally, the practice of flash orders should be explicitly ruled out

23. Calls for an investigation into fee structures to ensure that execution fees, ancillary fees and any other related incentives are transparent, non-discriminatory and consistent with reliable price formation and are designed and implemented so as not to encourage trading for improper purposes
24. Suggests 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
25. Asks that European trading venues have robust volatility interrupts and circuit breakers which operate simultaneously across all trading venues to prevent a US style "flash crash" event

### **Scope**

26. Mandates that no unregulated market participant can gain direct or unfiltered sponsored access to formal trading venues and that significant market participants trading on their own account need to register with the regulator and allow their trading activities to be subject to an appropriate level of supervision and scrutiny
27. Calls for proprietary trading activities conducted via algorithmic trading strategies by unregulated entities to be transacted solely through a regulated financial counterparty
28. Calls for the extension of the scope of MiFID to all "equity-like" instruments including: Depository receipts (DRs), Exchange Traded Funds (ETFs), Exchange Traded Commodities (ETCs), and certificates
29. Requests the consideration of introducing a transparency requirement, pre and post trade, on all non-equity financial instruments subject to significant secondary trading, including government and corporate bond markets, to be applied in an asset specific manner
30. Supports the Commission's intention to include derivative instruments within the scope of MiFID as the trading of such products transitions increasingly to formal trading venues and are subject to increasing standardisation and central clearing requirements
31. Requests a review of the IOSCO standards for clearing houses, securities settlement systems and systemically important payment systems addressing any weaknesses concerning market opacity
32. Instructs its President to forward this resolution to the Council and the Commission, and to the European Central Bank.

## EXPLANATORY STATEMENT

The European capital markets have undergone a period of unprecedented change, both due to a changed regulatory environment, post MiFID implementation, and due to the technological advancements over the same period. The introduction of MiFID has also overlapped with a period of externally imposed volatility due to the financial crisis. As a result, even if reliable market data were available across all trading venues, the quantitative data does not solely reflect the regulatory impact.

In the last five years, the monopoly position of primary exchanges has been transformed. Less than 60% of trading volume in the UK FTSE 100 takes place on the LSE, whereas 30% of the CAC40 now takes place outside Euronext in Paris and 25% of the DAX30 trading takes place outside the Deutsche Bourse in Frankfurt. It seems that across all players there is recognition that the abolition of the single primary venue for equities trading has secured greater competition between trading platforms.

This key objective of MiFID, to promote competition between trading venues for execution services, has led to increased investor choice, lowered transaction costs and has helped increase the efficiency of the price formation process. There are now 136 MTFs operating in the EU, as well as the primary exchanges which collectively make up the organised trading venues. These organised venues account for some 60% of the trading volume with the remainder being carried out by broker-dealers, collectively termed OTC. Bilateral trades, where the client gives the broker an order and he finds a match, have migrated from mainly verbal orders to predominantly electronic orders. Although by definition there is no pre-trade transparency for OTC trades they are still required under MiFID rules to be reported.

Market fragmentation has however led to poor post-trade transparency as a result of spreading trading over various venues and in particular on the quality of the post-trade data. A more effective regulatory framework for consolidated post-trade information is required which encompasses new technical codes in the settlement process to better reflect an environment where traders can execute on multiple venues. Regulators need to ensure that they can, at any time, recreate the order book in order to understand the market dynamics and participants involvement. Regulatory intervention also seems necessary to remove the outstanding barriers to the consolidation of post-trade data in order to establish a privately run European Consolidated Tape system.

Data costs in the US are significantly lower than in the EU and can be as low as \$50 dollars per month for all platforms while running to \$500 in the EU. This is primarily due to the bundling of pre and post trade data by the trading venues, hence the need to unbundle these data sources and thereby lower costs significantly. Inconsistent trade data quality and lack of common data reporting formats have further compounded the problems and can be resolved by drawing up common reporting standards and formats for the reporting of post trade data.

MiFID also detailed a permissible delay in post-trade reporting and, given the increased use of technology, it seems appropriate for price formation purposes that this limit be reduced so no transaction can be reported later than 24 hours after it took place and, with regards to most

electronic transactions, delays of more than 1 minute should be considered unacceptable.

As well as the crisis, many other changes to the market place have also occurred since the introduction of MiFID, such as the advent of new technology and the now widespread use of electronic algorithmic trading, including HFT. In this new technological era and in recognition of the increased requirement for transparency, it is interesting to note that the volume of trades conducted OTC has not diminished as a percentage of overall trading volume since the increased number of venues has appeared. However, the market has adjusted to the use of dark pools for trading large orders (BCNs) and the use of MiFID exemptions for such actions when they are conducted through organised trading venues (dark transactions).

Approximately 10% of all trading in EEA equities shares on organised markets use the MiFID pre-trade transparency waivers and can be considered to be trading "in the dark". A balance however must be struck between the need for pre trade transparency to aid price formation and the justified situations where waivers have been granted to prevent undue market movement and aid the functioning of the market. Given that the average trade size has reduced from €22,266 in 2006 to €9,923 in 2009 and only 0.9% of trading is now conducted under the "Reference Price" waiver there is grounds for a review of the different waivers. Care also needs to be taken to ensure that there is a more uniform application of the pre-trade waivers across Member States to limit implementing differences; technical standards could be an appropriate way of achieving this.

Executing OTC trades through broker-dealer crossing networks existed pre-MiFID but have now predominantly become electronic platforms for clients. BCNs are accepted as a valuable addition to the venues for buy-side orders in particular, and so should be recognised as a category within MiFID and be subject to regulatory oversight in order to monitor their activities.

CESR is currently conducting a data capture exercise in order to correctly assess the volume of trades being conducted in the dark and whether there is a limit as to what volume of the market, trading without pre-trade price disclosure, actually begins to impact the process of price formation itself. The US market for regulating diverse trading platforms is more advanced than in the EU and we need to investigate whether lessons can be learnt from the US on post trade transparency for dark pools, especially as currently the UK FSA estimates less than 1% of equity trading is conducted in the dark by OTC contracts, whereas in the US, dark pools account for closer to 10% of trading volumes.

Since MiFID, market infrastructure providers have increasingly become technology platforms heavily dependent on IT systems, competing to provide the most efficient, rapid and resilient trading facilities. Regulatory changes aside, the impact of new technology and the advent of new market participants has led to faster trading speeds, the growth in HFT and an increase in direct market access by clients of trading platform members and therefore to faster and more dynamic markets.

One of the reasons for the steady decline in the average trade size is that the new market participants place a premium on immediate execution of orders and not on displaying large orders. Any well functioning market requires firms willing to provide liquidity and make public prices. Traditionally, specialists and market makers have carried out this function by quoting 2 way prices and generating revenue from the spread. As the market has evolved, the

way in which the provision of liquidity is implemented has changed. In particular, with the advent of technology, algorithmic trading firms are now providing liquidity in the markets by posting 2 sided orders onto electronic order books and making a public price. Market makers typically do not hold investments for any length of time and therefore HFT strategies have evolved to capitalise on this function. It would seem appropriate that further analysis be done on the obligations and responsibilities that may be required of these informal market makers. If they are benefiting from a market maker pricing structure they should be obligated to provide a market price when required.

HFT is not a trading strategy in itself but can be applied to a variety of trading strategies which all have high portfolio turnover in common; many can process up to 33,000 trades per second, with sub microsecond roundtrip times for trading. They all have a requirement for speed and are therefore latency sensitive, requiring high capacity market data feeds and trade matching and quoting engines. They typically fall into two categories: electronic market making and statistical arbitrage. It is estimated that the volume of trading conducted by HFT traders is in excess of 35% and rising. This is compared to 70% of volume transacted in the US markets where it is less expensive to operate a HFT strategy. It is expected that the costs in the EU of clearing and settlement are a barrier to further expansion and so any reduction in costs is likely to have an additional effect on the market dynamics.

Little data is available for the impact these HFT strategies are having on the market and in particular as to whether the aggregate impact of technology could impact the resilience of the market itself. It would seem that HFT has increased liquidity and has tightened the spreads for investors; however, further investigation needs to be carried out to ascertain whether the quality of this liquidity is useful as often there is little volume at the touch and questions arise over the validity of the depth shown on order books. Analysis also needs to be carried out to determine whether price formation has also been impacted negatively by the increase in HFT.

An observation has been made that many of these HFT players are operating as proprietary trading houses and are as such unregulated entities and therefore do not need to comply with MiFID rules. Given that there is a political mood for all significant market participants to be appropriately regulated, we suggest that this should apply to these firms, with the expansion of MiFID reporting rules to cover these entities being required as a matter of urgency. In particular there needs to be oversight of the systems and risk management of these firms as demonstrated by the US "Flash Crash" on May 6th. Stress testing of platforms should be carried out to ensure that they are capable of dealing with a "runaway algorithm". Data capture of all market participants' activity needs to be prioritised to enable regulators to reconstruct order books, when necessary, to monitor the functioning of safe and efficient markets. Given the volume of transactions, it would seem that they may pose a systemic risk to the system which needs to be investigated pan-EU.

The use of co-location is becoming commonplace as placing client servers in close proximity with trading servers enables a trading firm to reduce the time taken to receive market data from the trading venue and to place orders into the market, thus reducing latency and enabling the firm to trade more frequently. This can also be achieved through third party proximity hosting. Although costly, the option to co-locate does not seem discriminatory at this time and although all users should be treated equally in terms of distance from servers and pricing, a requirement to provide information on how prices are set seems necessary.

Sponsored access permits traders who are not market members to route their orders through a sponsor's system such as a broker-dealer or general clearing member (GCM). EU platforms who currently allow sponsored access namely Chi-X, BATS Europe, LSE and NYSE Euronext, have, under the supervision of their regulator, introduced requirements for filters and controls that the member applies before the orders are transmitted. However, unfiltered (naked) sponsored access permits an intermediary's client to connect directly to the platform without any other form of supervision, this practice poses unacceptable risks to the market member and its clearing facility and to the orderly function of the market and should remain prohibited in the EU. It is suggested that proper pre-trade risk controls and post-trade monitoring systems must be established for sponsored access to platforms, especially for those using a "clearing firm" where sponsored clients can operate in the markets using significant leverage, potentially causing a systemic risk to the system given the potentially large intraday positions across the many strategies.

In conclusion, it seems that a significant consequence of the competition brought about by the implementation of MiFID has been market fragmentation which has in itself encouraged the explosive growth of HFT strategies. Regulation needs to recognise that these technological advances are in need of suitable provisions in the legislation in order that they do not fall through regulatory gaps and inadvertently cause systemic risk to the overall functioning of the markets.