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**CALL FOR EVIDENCE**

**Micro-structural issues  
of the European equity markets**

**Deadline for contributions:** CESR invites responses to this call for evidence by **30 April 2010**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at [www.cesr.eu](http://www.cesr.eu). All contributions received will be published following the close of the call for evidence, unless the respondent requests its submission or any annex containing commercially sensitive information to be confidential.



## Introduction

1. More than two years have passed since the implementation of the Markets in Financial Instruments Directive (MiFID). The Committee of European Securities Regulators (CESR) conducted a first evaluation of the workings of the new regulatory framework and its impact on market structure in equity secondary markets early 2009. The respective report on the impact of MiFID on equity secondary markets functioning was published on 10 June 2009 (<http://www.cesr.eu/popup2.php?id=5771>).
2. In its report CESR raised a number of issues which will be addressed in the context of its MiFID review work. However, since the publication of CESR's report a number of technology-driven developments have intensified such as high frequency trading, sponsored access and co-location. Although these topics were not explicitly included within either the aforementioned CESR report or the MiFID Article 65 review clauses, CESR intends to assess these developments in greater depth due to their potential effects on overall equity market structure and the efficiency of those markets in the EU.
3. To assist this process, CESR is undertaking an evidence-collecting exercise. This will help it in assessing the impact of some of the latest developments in European equity markets and may also inform aspects of this year's MiFID review (or any other CESR work streams, if appropriate). Specifically, CESR seeks information on the issues listed below:
  - high frequency trading
  - sponsored access
  - co-location services
  - fee structures
  - tick size regimes
  - indications of interest

## Call for Evidence

4. CESR invites interested parties to submit their views in response to the questions set out below and on any related topic in respect of micro-structural issues that might be in the interest of CESR to address.

### **I. High frequency trading (HFT)**

5. HFT is a form of automated trading and is generally understood as implying speed. Using very sophisticated computers and IT programs, HF traders execute trades in matters of milliseconds on electronic order books and hold new equity positions possibly down to a "sub-second". HFT generally involves getting in and out of positions throughout the day with a 'flat' position at the end of the day. HF traders use their own capital and do not act on behalf of clients. HF traders follow different strategies (eg. arbitrage, trading on prices which appear out of equilibrium, trading on perceived trading patterns, etc.) but are generally geared towards extracting very small margins from trading financial instruments between different trading platforms at hyper fast speed. HFT is different from what is generally referred to as algorithmic trading or black-box trading, based on the use of computer programs for entering orders with the computer algorithm deciding on individual parameters of the order such as the timing, price, or quantity of the order.

### **Questions:**

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



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

5. **What are the key benefits from HFT? Do these benefits exist for all HFT trading strategies?**
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?**
7. **Overall, do you consider HFT to be beneficial or detrimental to the markets? Please elaborate.**
8. **How do you see HFT developing in Europe?**
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?**

CESR would also be interested in receiving analytical studies on the impact of HFT on market efficiency.

## **II. Sponsored access**

6. **Sponsored access (SA) is an adaptation of the concept of direct market access (DMA). Under DMA arrangements, clients of firms that are members of an organised trading platform can access the trading platform directly without becoming members themselves. Under such arrangements, clients submit orders to the trading platform by routing them through the firm's internal system. SA is similar, except clients send orders directly to the trading platform without passing through the firm's internal system. Under both types of access the firm retains full responsibility for all orders submitted by its clients.**
7. **In the absence of proper controls, SA may present additional risks to those posed by DMA for trading platforms and intermediaries. On the market side there may be, for example, increased risk of error trades and potential for market abuse. On the intermediaries' side, credit risk could arise from the inability of sponsors to monitor their clients' business (and therefore their exposure) in the absence of suitable controls.**



8. The SEC recently announced new measures in relation to sponsored access<sup>1</sup>. They are proposing to i) prohibit 'naked' or 'unfiltered' SA whereby clients' orders are entered into the trading platform without any prior control by the relevant firm and ii) to require broker-dealers to establish, document and maintain a system of risk management controls and supervisory procedures designed to manage the financial, regulatory and other risks related to its market access, including access on behalf of sponsored customers.
9. IOSCO has published a consultation document on *Policies on Direct Electronic Access*<sup>2</sup>. The consultation document considers risks arising from SA for organised trading platforms and firms providing SA to their clients and proposes a number of principles aimed at addressing these potential concerns

#### Questions:

1. **What are the benefits of SA arrangements for trading platforms, sponsoring firms, their clients and the wider market?**
2. **What risks does SA pose for the orderly functioning of organised trading platforms? How could these risks be mitigated?**
3. **What risks does SA pose for sponsoring firms? How should these risks be mitigated?**
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.**
5. **Are there other market wide implications resulting from the development of SA?**

### III. Co-location

10. Co-location is a service offered by organised trading platforms aimed at minimising the latency of order submission and market information transmission by allowing trading participants to locate their devices (e.g. computer servers) in close physical proximity to the trading platform's matching engine. As a result, co-location helps minimise network and other latencies between the matching engine and servers of trading participants. It can also increase access speeds and enable trading participants using these services to execute orders faster than trading participants which do not. For this reason, co-location services are often attractive to HF traders. Conceptually, co-location of technology is akin to an individual broker/dealer being in close proximity to market makers on the trading floor of an exchange.

#### Questions:

1. **What are the benefits of co-location services for organised trading platforms, trading participants and clients/investors?**
2. **Are there any downsides arising from the provision of co-location services? If yes, please describe them.**
3. **What impact do co-location services have on trading platforms, participants, and the wider market?**

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<sup>1</sup> SEC website: <http://www.sec.gov/news/press/2010/2010-7.htm>

<sup>2</sup> IOSCO Website <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD284.pdf>



4. **Does the latency benefit for firms using co-location services create any issues for the fairness and efficiency of markets?**
5. **In your view, do co-location services create an issue with the MiFID obligations on trading platforms to provide for fair access?**
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.**

CESR would also be interested in receiving any statistical material on the extent to which co-location services are provided/used in Europe.

#### **IV. Fee structure**

11. Some trading platforms structure their trading fees in a way that rewards the initial placers of orders<sup>3</sup> out of a higher fee that they charge to participants that lift those orders<sup>4</sup> – the so-called ‘maker/taker’ fee structure. In some cases, the initial placers of orders pay a fee but a lower fee than the lifter of the order; in others, they receive a payment. Some platforms have also been interested in incorporating this ‘transfer’ into the traded price rather than effecting it directly through the trading fee charges. The maker/taker fee structure is used by a number of trading platforms, including the new entrants, to attract liquidity to their venues. These pricing schedules are often considered to be part of the bid-offer spread.

#### **Questions:**

1. **Please describe the key developments in fee structures used by trading platforms in Europe.**
2. **What are the benefits of any fee structures that you are aware of?**
3. **Are there any downsides to current fee structures and the maker/taker fee structure in particular? If yes, please describe them.**
4. **What are the impacts of current fee structures on trading platforms, participants, their trading strategies and the wider market and its efficiency?**
5. **How important is the fee structure of a trading platform in determining whether to connect or not to it for trading. Please elaborate.**
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.**
7. **Is there a role for regulators to play in the fee structures? If yes, please describe it.**

#### **V. Tick size**

12. A tick size is the smallest increment (tick) by which the price of shares, futures contracts or other exchange traded instruments can move within the order book. Tick sizes can be uniform across all shares (e.g. USD 0.01 in the US except for shares that trade below USD 1) or set at a number of different levels according to the price of a share. Shares that trade at

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<sup>3</sup> Often also referred to as „liquidity provider“.

<sup>4</sup> Aggressive orders such as fill-or-kill (FOK) or immediate-or-cancel (IOC) are commonly used when lifting the order.



higher price levels often trade with larger tick sizes. Generally, more liquid shares are given smaller tick sizes. The differences often reflect the potential costs of liquidity provision in a share. The absolute size of ticks and changes to that size, have implications for bid-ask spreads, liquidity, market depth and volatility. The use by trading venues of different tick sizes for the same share presents additional issues.

13. The implementation of MiFID has resulted in a variety of new trading platforms with tick size regimes that are different from those used by the primary exchanges. From the perspective of each trading venue, there are incentives to offer lower tick sizes. Smaller tick sizes than the primary exchange may provide for cheaper trading and create opportunities to realise profits by trading between the platform and the primary market. However, there may be a point when this competition may no longer be in the interests of market participants and market efficiency. This now appears to have been recognised in the EU. In June 2009, a number of MTFs and the Federation of European Securities Exchanges (FESE) announced their intention to restrict further tick size reduction, simplify the complexity and align certain tick size regimes in Europe (at that time there were approximately 25 different regimes in the EU)<sup>5</sup>.

#### Questions:

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?**
2. **What are the benefits/downsides of smaller tick size regimes for shares in Europe?**
3. **Is there a need for greater harmonisation of tick size regimes across Europe? Please elaborate.**
4. **Is there a role for regulators to play in the standardisation of tick size regimes or should this be left to market forces?**
5. **Have organised markets developed an appropriate approach to tick sizes?**
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?**
7. **What principles should determine optimal tick sizes?**

CESR would be particularly interested in receiving information about analytical studies on the impact of the tick size reduction in Europe in recent years beyond the second decimal.

#### VI. Indications of Interest (IOIs)

14. Indications of interest (IOIs) is the name commonly used to refer to messages sent between investment firms to convey information about available trading interest. IOIs are also used by investment firms that operate organised trading venues and other broker dealers that do not offer pre-trade transparency (“dark pools”).
15. IOIs are used by dark pools to attract order flow and to maximise trading opportunities by enabling investors to find the contra-side of orders. The information provided in an IOI can

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<sup>5</sup> See FESE website <http://www.fese.eu/en/?inc=cat&id=34>.



include the symbol of the security, the side (i.e. buy or sell) and volume/price of trading interest.

16. In the US, the SEC's proposals on dark pools raise concerns with IOIs where they are used to provide valuable information to a select group of market participants. The SEC is concerned that IOIs create the potential for two-tiered markets and may reduce the quality of quotation data made available to the public. To address those concerns, the SEC proposes to amend the Regulation NMS definition of bid and offer to include 'actionable' IOIs<sup>6</sup>.
17. It is important to note that the US framework for transparency is different to the MiFID regime. However, some of the issues raised in the US may have relevance for European markets. For example, MiFID requires pre-trade transparency as an overarching principle for regulated markets (RMs) and multilateral trading facilities (MTFs). It is unclear where IOIs stand within this framework.
18. In addition, MiFID requires RMs/MTFs to have non-discretionary rules for fair and orderly trading. If IOIs were used to provide information to a select group of market participants to the exclusion of others, this may be inconsistent with the intention of MiFID.

#### Questions:

1. **Please provide further information on how IOIs are currently used in European markets by investment firms, MTFs and RMs?**
  2. **Which are the key benefits/downsides of such IOIs? Please provide evidence to support your views.**
  3. **Do you consider that MiFID should be amended to clarify that actionable IOIs should be subject to pre-trade transparency requirements?**
  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.**
19. All contributions should be submitted online via CESR's website under the heading Consultations at [www.cesr.eu](http://www.cesr.eu) by 30 April 2010. All contributions received will be published following the close of the call for evidence, unless the respondent requests its submission or any annex containing commercially sensitive information to be confidential.

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<sup>6</sup> SEC website: <http://www.sec.gov/news/press/2009/2009-223.htm>. An IOI is considered to be actionable when it includes the symbol of the shares, the quantity, the price and the side of the order (whether it is a sell or a buy).