Zurich, 10 May 2013

IOSCO Consultation: Regulatory Issues Raised by Changes in Market Structure

Dear Sir/Madam

We respond to the IOSCO Consultation, CR03; March 2013, regarding the Regulatory Issues Raised by Changes in Market Structure.

We thank IOSCO for the work conducted on these structural issues and welcome the opportunity to participate in the assessments by contributing to this public consultation on such important topics.

SIX Swiss Exchange

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SIX Group\(^2\)

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SIX publishes regular statistics on our market activity. This information can be found at: http://www.six-swiss-exchange.com/statistics/overview_en.html

General Comments

SIX Swiss Exchange welcomes the work by IOSCO to identify and analyse the various regulatory issues raised by changes in market structure. This is especially pertinent given that European legislators are currently negotiating the review of the Markets in Financial Instruments Directive (MiFID I). In its proposal for a new MiFID II, the European Commission has stated that “market and technological developments” have outpaced various provisions covered in MiFID. They also state that market developments since MiFID have partially challenged the current regulatory framework applicable to different types of

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\(^1\) Source: FESE European Equity Market Report & Thomson Reuters Market Share Report

\(^2\) www.six-group.com
execution venues, i.e. Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) and Systematic Internalisers (SIs). This is a clear indication of the necessity to refine the present framework. The overarching aims of the MiFID review are to enhance investor protection, ensure strong organisational requirements, identical transparency rules and enhance key requirements across all European trading venues. This is necessary due to the increased competition and cross-border trading now prevalent in the markets, by technological advances in market infrastructure and MiFID I.

We support the goals of the MiFID review; to further competitiveness and efficiency in European markets and to ensure a level playing field for the operators of such venues. This IOSCO consultation is timely as it allows for contributions which can assist legislators and regulators to address the issues of the current and increasing market fragmentation.

SIX Swiss Exchange considers the following key themes material to this consultation:

- **Regulators must prevent the creation of further unintentional fragmentation and the detrimental erosion of the public price formation process:** In Europe, MiFID I has successfully created greater competition between trading venues, which is partially evidenced by reduced trading tariffs. This has led to greater market and liquidity fragmentation, as a natural consequence, but has also led to some anomalies which have allowed material amounts of activity to be conducted away from price forming venues. This activity does not form part of the neutral and transparent price formation process. Regulators should consider the impact of any further regulatory proposals that could potentially drive further fragmentation and erosion of the price formation process and transparency with the negative effects for investors.

- **Increased fragmentation could create a two-tier market:** Increased OTC trading with restricted access to liquidity pools could create a two-tier market which risks leaving small and midsize companies behind as in practice, only few investors will have the possibility to access prices displayed by the broker-dealer run platforms.

- **Necessity to ensure that the majority of trading takes place on neutral and transparency venues:** Regulators should take into account the benefits for all markets participants brought about by increased trading on neutral and transparent venues. These venues positively contribute to the provision of liquidity pools, price formation and the assessment of best execution for clients. These benefits are not provided by venues which are not neutral, are not transparent and are not open to all investors.

- **Regulators should assess the impact of non-open and non-neutral venues on the real economy:** In particular the affect such non-open and in-transparent venues will have on the wider integrity of the market and in the context that the benefits of such arrangements should be significantly material to outweigh the detrimental effects they would have by not participating in public venues activity.

**Regulators need to better understand the impact of fragmentation:**

The increased fragmentation caused by the introduction of MiFID I is one of the key aspects to consider during the discussion by legislators on the proposals for MiFID II. Market structure for all asset classes (i.e. venue classification) is extremely important as it is the basis for every other component of regulation. This is because the market structure determines how the rules attached to each type of trading are applied. In this regard there are a number of concerns which arise when considering the affects that increased fragmentation has had on the relevance, effectiveness or implementation of current regulatory requirements.

To commence such an assessment regulators need to clearly understand what has been happening in the European equity markets since the introduction of MiFID I and a comprehensive overview of the big picture is necessary in order to see where and how trading is executed and how it is regulated. Currently
there is limited acknowledgement of how the evolution of MiFID has fundamentally changed the market structures currently operating.

The introduction of MiFID I has had a significant impact on market structure as trading has moved further away from neutral and transparency venues. There are disputes over the actual volumes traded within the OTC space and how much of this activity is trading which should form part of the price formation process. The figures range from 38%³ (publicly available data) down to 16%⁴ (market actors private assessment). The fact that a full transparent picture of the trading activity is not readily available is itself an important revealing fact that needs to be included in the review. This is primarily necessary because the public figures on OTC are so unreliable which proves the necessity for the supervisors to enhance the reporting regimes and tools to enable them to get a comprehensive view of the markets and the impact of market fragmentation.

It is worthy of clarification that the majority of comments made in our response relate to the operation of the equity markets. Whilst some aspects are capable of re-use for other products types a one size fits all approach is not appropriate in all cases.

Should you have any questions arising from this response please do not hesitate to contact:

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Response to the Consultation Report:

**Recommendation 1**

1.1 Regulators should regularly monitor the impact of fragmentation on market integrity and efficiency across different trading spaces and seek to ensure that the applicable regulatory requirements are still appropriate to protect investors and ensure market integrity and efficiency, including with regard to price formation, bearing in mind the different functions that each trading space performs.

1.2 Regulators should regularly evaluate the regulatory requirements imposed on different trading spaces and seek to ensure that they are consistent (but not necessarily identical) across spaces that offer similar services for similar instruments.

Questions:

1. Does the evolving market fragmentation challenge the relevance, effectiveness or implementation of current regulatory requirements? If so, which ones and how are they impacted?

**Define the existing trading boundaries with greater clarity:**

The fundamental challenge arising from the experience of MiFID I in respect of equities market structure is the need to appropriately set the boundaries between organised trading on, regulated venues, RMs, MTFs and SIs and conversely in, unregulated platforms, over-the-counter trading (OTC). Both groups are legitimate and should be part of European market structure, but there is a need to appropriately frame the boundaries between them. This is because one of the main unintended consequences of MiFID I was the emergence of much greater trading volumes trading in OTC environments, in part due to increased fragmentation. The regime established by the MiFID I is in many aspects satisfactory, and only requires clarifications to achieve these aims. MiFID already requires anyone operating an RM/MTF (multilateral) or SI (bilateral) to do this business subject to a set of safeguards. These are intended to ensure that any liquidity pool set up will result in properly priced trades, will be accessible to all investors, and will be monitored for market integrity. However, there is a need to explicitly clarify and firmly implement the provisions in a uniform manner.

**Clarify what equity trading can take place away from organised venues:**

In order to tackle increased fragmentation and to ensure that the same business is subject to the same rules, regulators must consider clearly defining what trading activities should and should not be conducted utilising the OTC regulatory freedoms. As OTC trading is subject to less stringent (or no market facing rules) than existing multilateral and bilateral venues under MiFID I, regulators must ensure that an increasing number of venues are not allowed to conduct trading in identical forms in competition to regulated venues but subject to lighter rules. This should be based on existing definitions with additional clarifications to remove ambiguity. As a means to tackle increased fragmentation there is a need for regulators to adopt the approach of ‘same business, same rules’ to platforms that carry out multilateral and bilateral trading. We urge regulators to address again the fundamental issue at hand in respect of equities markets trading: the lack of a clearly defined boundary between organised and OTC trading. If no boundaries are set, trading in equity and equity-like instruments will continue to gravitate towards OTC since investment firms will be completely free to choose between executing on a multilateral, bilateral or OTC basis. This would come at the expense of investor protection and of the efficiency of price
formation on European markets and would maintain or even deteriorate from the existing status quo and inefficiencies resulting from MIFID I.

The outcomes of the revised regulatory framework must be capable of effective enforcement. This could be achieved by avoiding overly complex regulation, regulation which lacks clarity and is open to interpretation and implementing mechanisms to assess compliance with the framework. Without this the framework will not deliver optimal outcomes.

2. **Are you aware of material differences in regulatory requirements between different trading spaces that from your point of view are not justified and create regulatory risks and unfair competition?** For example, are there regulatory requirements that apply to one type of trading space in your jurisdiction and currently do not apply to others but, in your view, should apply to others that offer similar services? Please describe.

As previously stated, European legislators are currently negotiating a review of the existing securities trading rules. We support the aims of this review to ensure that the same business is subject to the same rules; however, there are certain aspects of the proposals from the European Commission that we do not believe will solve the issue of fragmentation.

The creation of a new venue type Organised Trading Facility (OTF) will endanger price formation, efficiency and fairness. If regulators approve the creation of the new OTF category, which can offer discretionary execution, this would have serious consequences for the quality of markets. In addition to further fragmenting Europe’s already fragmented markets, the proposals would endanger proper price formation, the efficiency and fairness of markets, and hinder competition among trading platforms. We would rather see a functional approach to these issues which will ensure proper market regulation, namely venues which perform the same business have to be subject to the same rules. For this reason, multilateral trading of equities – wherever it takes place - should only happen on platforms that provide identical rules on transparency, non-discretionary execution, non-discriminatory access, and full market surveillance. Without such a functional approach the provisions to create a new OTF category are likely to result in further attrition of activity from the neutral and transparent venues onto the private and in-transparent OTF environments which will further erode price formation due to the ability to operate discretionary execution.

3. **Do you think that the price formation process has been deteriorated or has been improved as the result of market fragmentation? If so, please explain how.**

Price formation has not been improved as a result of market fragmentation. Efficient price formation is hindered by increasingly fragmented pools of liquidity. In order to ensure that price formation works properly and that all investors have access to all liquidity pools directly or indirectly, all platforms must be open to all investors. However, currently the OTC platforms are not open to all investors which results in an unlevel playing field among trading venues and trading participants and creates a two tier market.

Unless there is a valid and approved justification, i.e. pre-trade transparency waiver, to be exempt from pre-trade transparency, all equity trading activity should contribute to the price formation process. Therefore, European regulators should ensure that the there is harmonised implementation of the trading venue rules to ensure an efficient price formation process and apply ‘same business, same rules’ to each venue.
Recommendation 2

In an environment where trading is fragmented across multiple trading spaces, regulators should seek to ensure that proper arrangements are in place in order to facilitate the consolidation and dissemination of information as close to real time as it is technically possible and reasonable.

Questions:

1. What options are available to manage the issues associated with data fragmentation in a competitive environment?

   European legislators are discussing a number of options for data consolidation. We believe that a competing solution for post-trade data consolidation (‘Competing Consolidators’) is the best option to bring together European equity data in a reliable, comprehensive and efficient way. This will allow for innovative solutions to be delivered to data users as they are often requiring different solutions to meet their business needs. By contrast, the introduction of a bureaucratic post-trade data consolidation process via one Central Consolidated Tape would be violating the spirit of MiFID I and of the competitive European internal market and would not facilitate the different requirements of the users.

2. What conditions, if any, should govern access by investors to consolidated market data?

   Data should be available to all investors and depending on their usage, their re-use for commercial purposes and data complexity; should be charged appropriately, see our response to Q4 below. As an example data is currently free of data license fees after a 15 minute delay.

3. Are there other challenges (technical, regulatory, prohibitively high costs) with regard to creating and/or accessing consolidated market data? What if anything, should be done to address these challenges?

   There are number of challenges for creating consolidated market data. However, there are already numerous competing consolidated tapes operating in Europe. This reflects many years of development efforts by the industry, but suffers from the lack of regulatory harmonisation of data and the absence of reliable OTC data. In this regard the Commission has proposed the introduction of an Approved Publication Arrangement (APA) regime for trade data publication by Investment Firms (IFs) and SIs in order to improve OTC data quality.

4. What views do you have on the relative merits of a single consolidated tape mandated by the regulation versus multiple competing tape providers? Please elaborate.

   We believe that a competing solution for post-trade data consolidation (‘Competing Consolidators’) is the best option to bring together European equity data in a reliable, comprehensive and efficient way, as outlined in response to Q1 above. The free market is the best placed mechanism to determine the value of data. It should be up to the market to determine what the value of RM, MTF or OTC data is. It also is best placed to determine what needs to be achieved for any future data consolidation activity. The priority should be to tackle the current lack of granularity and poor quality of OTC post-trade data. This can be achieved by better regulatory classification of OTC trading and better standardisation of OTC data reporting requirements via the introduction of Approved Publication Arrangements (APAs) for OTC. Regulation is necessary to achieve these aims as market participants are
reasonably hesitant to adopt any industry led initiative for post-trade data consolidation which may not have the future support of regulators as this could increase cost if alternative solutions are eventually implemented.

We outline below our views on why the competitive model is superior to a central consolidated tape:

- A single, monopolistic consolidated tape would not solve the main problem faced by consumers of data, namely a lack of transparency and harmonisation of OTC trade data. By contrast, the introduction of APAs to publish OTC post-trade data does aim to address the quality, availability and consistency of OTC data. Contrary to common beliefs, there are already numerous competing consolidated tapes in Europe, but these suffer from the lack of regulatory harmonisation of data and the absence of reliable OTC post trade data. Once these issues have been solved, the existing solutions for data consolidation will be fully capable of delivering enhanced information based on a standardised set of technical rules and guidelines. These are due to be developed by ESMA and should fulfil all users’ expectations.

- A single consolidated tape would introduce additional unintended consequences to Europe. In addition to removing competition, innovation and efficiency – contrary to the principles of the Internal Market - it is more than likely that it would also change the market microstructure of European markets. This is because it will introduce the possibility of “tape gaming” for data revenues – whereby trading venues have the perverse incentive to generate trading volumes that may not reflect true price formation simply to gain a share of data revenue. This is a serious and inevitable problem with any central system – creating an overly complex, distorted and unrepresentative trading environment. The US authorities, for example, have not been able to find a satisfactory solution to this issue. In order to avoid such problems inherent with the US model, the competing solution should be preferred.

- Instead of building a new and costly consolidated tape from scratch, existing infrastructures operated by data service providers should form the basis of the new regime.

- The ‘Competing Consolidators Model’ would retain and enforce incentives which will provide for flexibility, innovation and high quality services.

- Finally, the ‘Competing Consolidators Model’ avoids the establishment of a monopoly and thus the creation of a single point of failure.

Moreover, multiple competing tapes provide benefits for market participants and investors:

- The market data industry currently operates CTP infrastructures which remain capable of delivering the aims envisaged in the original proposals subject to being fine-tuned through the introduction of common rules and standards implemented by MiFID and Regulatory Technical Standards which will be defined by ESMA.

- Multiple competing tapes would be available both as a real-time consolidated data feed and as a 15-minute delayed data feed. Following the mandatory core set of standards, all of these tapes would offer consistent and similar information but each provider would design its product depending on the diversity of needs for its clients, offering the full benefits of competition.

- The provision of 15-minute delayed data, free of data license fees, would make data accessible and reliable at attractive terms for retail investors and fully address their requirements.
Additionally, in an increasingly fragmented equity trading environment, consolidated post-trade data can serve investor needs:

- MiFID has enabled inter-market and inter-venue competition which has yielded significant benefits for European markets but has also resulted in fragmentation of liquidity and the sources of data. Tackling the underlying problem with data in Europe, i.e. the lack of consistency, granularity and the poor quality of post-trade OTC data, will serve investors’ needs better than a single tape provider\(^5\).
- Consolidation of post-trade data, like other services provided in the European trading landscape, should continue to be subject to a competitive approach via a multitude of data providers which will increase the choice for investors and consumers of the services. We believe that the key is to get common data standards which will allow different CTPs to offer the same complete picture to their consumers in a flexible manner which meets their needs. Exchanges have led an industry initiative – the Market Model Typology (MMT) - which is offering a practical solution to implement certain standards before MiFID II comes into force.

**Recommendation 3**
Where markets are fragmented, regulators should consider the potential impact of fragmentation on the ability of intermediaries to comply with applicable order handling rules including, where relevant, best execution obligations, and take the necessary steps.

Questions:
1. **Should existing order handling rules, such as best execution, be re-examined in the context of fragmented markets?** If so, in what way?
2. **Do you think that rules relating to the disclosure of order handling practices by investment firms are appropriate to facilitate compliance with and evaluation of ‘best execution’?**
3. **Are there any other appropriate ‘order handling’ tools that should be considered in the context of fragmented markets?**

We support a re-examination of the order handling rules to ensure that all orders are handled efficiently and provide the highest level of investor protection. This should assess the order handling arrangements of intermediaries, the effects of internalising flows within the intermediary, payment for order-flow and any conflicts which may arise from ownership stakes in trading venues, to include but not limited to, where incentives are in place to provide order flow.

In particular, regulators must differentiate between the role of the broker and the role of the trading venue, i.e. that best execution is an obligation that the broker owes to the investor while non-discretionary rules are an obligation on the platform operator to the participants of the venue to ensure an orderly, transparent and fair market. Therefore, the market needs both rules.

However, it must be noted that the current “best execution” rules are not necessarily fully robust nor are they enforced consistently across Europe as there are so many divergent interpretations of the current rules which make assessment of best execution by investors extremely complex. The fragmented structures in place and the myriad post trade channels available to investors all results in different cost implications and therefore best execution cannot simply be based on best price. The lack of clarity of the

\(^5\) High-quality data is provided by RMs, which is subsequently made available through many channels and is being consolidated along with other available data – i.e. MTFs - by commercial providers.
rules, combined with an inability to effectively monitor compliance, raises further concerns about the conflicts of interest within the broker if activity is internalised or not placed on a public market. This results in the need to re-assess the current provisions. However, there are no significant changes to the best execution regime currently envisaged in the MiFID II review. We urge that this issue be re-assessed and improved for the sake of investor protection.

**Recommendation 4**

Regulators should regularly monitor the impact of fragmentation on liquidity across trading spaces.

Regulators should seek to ensure that applicable regulatory requirements provide for fair and reasonable access to significant sources of market liquidity on the exchange and non-exchange trading market systems.

**Questions:**

1. *Do you have views on regulatory mechanisms and specific arrangements that might be needed to help ensure that investors have an appropriate, fair and reasonable access to liquidity in both exchange and non-exchange trading market systems? If yes, please elaborate.*

   Effective pre-trade transparency rules are vital to ensure efficient price formation by allowing appropriate, fair and reasonable access to liquidity. Regulators should ensure that all multilateral venues provide fair and open access for market participants and that all multilateral trading should be non-discretionary to protect investors from arbitrary prices or conflicts of interest. Without these controls a platform operator might be tempted, for example, to give a better price to some clients that bring more business. Moreover, a marketplace in which the individual platforms do not deliver non-discretionary execution will have neither a proper price formation process nor proper investor protection. In all instruments, this will make pre-transparency meaningless, as quotes would not be executed at the displayed prices on the order book of the platform, hence would not contribute to price formation. There is evidence to suggest that some MTF operators operate with a single member, namely the venue operator, who sources activity into the platform from the investment firms’ (broker) clients. This clearly creates uncertainty over the neutrality and non-discriminatory nature of the venue operator and calls into question the price formation mechanisms operated on such platforms.

2. *Are there any other issues resulting from the market fragmentation that should be addressed with respect to access to liquidity on exchange and non-exchange trading market systems?*

   Regulators must review those brokers operating unregulated Broker Crossing Networks (BCNs) in which they execute trades multilaterally between their own clients using their own capital. We do not support any proposals which allow a multilateral trading platform operator to execute against its own capital (proprietary trading) within its own venue. RMs and MTFs, by their very nature of being multilateral trading venues, are (or should be) neutral platforms, hence the operator of a multilateral platform (such as the proposed OTF) should not be allowed to trade against the OTF clients (own account flow) as this would rise serious conflicts of interest. It is important to note that a multilateral trading venue operator is not involved in the financial outcomes of a transaction (i.e. they do not make a turn on the investment or price) and are only concerned with ensuring a fair and orderly trading environment. Whereas an investment firm operating on a market for own account is mainly concerned with the price as this is the factor
which delivers profit to the firm. The interests of the two parties are therefore diametrically opposed and this is why the operator of a platform cannot perform both roles simultaneously without creating serious conflicts of interest. In contrast some market participants argue that the proprietary trading ban could lead to a huge withdrawal of liquidity from the markets, particularly from the off-exchange derivatives market. Instead of a ban, banks argue that it would be possible to achieve fair and orderly trading by ‘rigorously’ implementing conflicts of interest rules. However, in light of current financial incidents such “self policed” arrangements may not prove as robust as clearly defined and delineated obligations which will ensure the markets and investor protections remain robust.

Yours faithfully

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