



European Regulatory Developments - Position Paper

BATS Chi-X Europe, the largest European equities exchange by market share and notional value traded, represents the combination in 2011 of the two leading pan-European multilateral trading facilities (MTFs), BATS Europe and Chi-X Europe. BATS Europe and Chi-X Europe were launched to help realise the benefits of increased competition between trading venues envisaged in the first Markets in Financial Instruments Directive (MiFID).

BATS Chi-X Europe – markets traded



BATS Chi-X Europe – a vision for Europe's financial markets

Developing a genuine integrated pan-European capital market is key to Europe's growth and global competitiveness. As the first truly pan-European equities exchange, BATS Chi-X Europe's ambition is to contribute to this effort. BATS Chi-X Europe offers investors access to trading in more than 1,800 of the most liquid equities across 25 indices and 15 major European markets, as well as in ETFs, ETCs and international depository receipts. BATS Chi-X Europe has approximately 25% market share of multilateral European equities trading (October 2012 market share: 24.78%. Source: BATS Global Markets).

Reviving Europe's economic growth and making Europe an attractive place to invest from a global perspective are on-going challenges that can be overcome with a single European market approach. Europe's economies will benefit from a market environment where companies, large and small, can easily access a large investor base to raise the capital they need to invest and grow, and investors can operate in a safe, transparent and efficient market that behaves with integrity. BATS Chi-X Europe offers a much larger investor base with order routed access to a pan-European capital market through a single entry point, as well as cost-effective access to other MTFs and 13 primary exchanges. By driving competition and innovation in the European equities markets, BATS Chi-X Europe is also contributing to reducing the cost of investing in the EU economy.

BATS Chi-X Europe also places great emphasis on market surveillance, using a pan-European system for monitoring and detecting potential market abuse and manipulation across European markets.

Five years and an unprecedented financial crisis have passed since MiFID I was implemented. The on-going review of MiFID ("MiFID II") is now the occasion to draw lessons as to whether and how cross-border market surveillance can be improved, markets can be made safer and more resilient, and transparency increased while keeping the important benefits brought by MiFID I.

Strengthening market controls

MAD/R, MiFID Articles 67 & 68

Need for a consolidated tape

The development of a competitive market place for execution has created new challenges for market supervisors. In particular, regulators and trading venue supervision teams must be aware of activity on other trading venues to be able to fully understand the activity on their home/own market. A genuine real time **consolidated tape, pre and post-trade**, is a prerequisite for more effective supervision. While, the technology is already available, the main barrier to a consolidated tape is the high cost of market data. We support efforts to bring down the cost of market data and speed up the creation of a consolidated tape through appropriate regulation.

Coordinated tools to manage disruptive market events

While markets have always been subject to extreme volatility events, the proliferation of trading venues has made the coordination of the management of those events more important. Technology developments and the increasing sophistication of the risk management controls and tools at venues have led to a more efficient and targeted management of those disruptive events – e.g. limit up/down controls and circuit breakers. What is now required is a common understanding about thresholds, tolerances and controls, and how they should be applied per instrument or class of instruments to ensure that responses to those events are co-ordinated and effective. This co-ordination can be achieved by using the consolidated tape as a common reference point.

Genuine cross-border market surveillance

In relation to **cross-market surveillance**, BATS Chi-X Europe supports the proposal that the competent authority of the primary listing venue for a given instrument should be responsible for such activity (unless a majority of trading activity is carried out on an alternative venue in a different jurisdiction, in which case the competent authority in that jurisdiction should have responsibility). However, that responsibility should not be delegated to a commercial entity, particularly where that entity is the market operator of the primary listing venue, as this will create conflicts of interest and compromise commercial confidentiality. If a competent authority does not have the resources to carry out this function, we would recommend that it delegates this task to another statutory regulator. In addition, we would recommend that requests for a venue's data should be via the home competent authority to ensure quality control and efficiency.

Trading in a transparent and resilient environment

Transparency

MiFIR Article 4

Transparency is crucial to the proper functioning of financial markets and MiFID I created a regime of full transparency for equity markets, while recognising the need to offer flexibility for certain transactions to avoid negatively impacting investors. MiFID I allows certain waivers from pre- and post-trade transparency. The experience of using those waivers has proved beneficial for European investors, particularly where the use of waivers encourage trading on regulated trading venues with central clearing.

An example of a beneficial waiver is **Negotiated Transactions** – the current MiFID waiver allows privately negotiated transactions to be formalised under the rules of a Regulated Market or MTF, provided that they meet certain price conditions. This allows what would otherwise be OTC business to become subject to formal trading venue rules and supervision and to be routed to central clearing. Removal of this waiver would force business to become less transparent – potentially moving to less well regulated alternative venues/instruments. For example, under both MiFID I and MiFID II, OTC business, including that transacted by Systematic Internalisers, is not subject to real time, third party market supervision.

The Negotiated Transaction waiver also facilitates order routing to alternative MTFs and Regulated Markets, providing users a cost effective way to direct orders to a wide range of venues, improving the likely quality of execution at a lower cost than connecting to multiple venues directly. The ability to bring the routed element of the trade back on to a trading venue as a Negotiated Trade interposes the CCP between the Participant and the routing broker and contributes to reducing counterparty risk on both sides.

Another example is the **Reference Price waiver** - The Reference Price waiver allows investors to trade blocks of securities while minimising market impact, and reducing the need to pay a risk premium to intermediaries for assuming the risk on their behalf. The Large In Size waiver is not sufficient to facilitate this business as it is highly unlikely that there will be an equal and opposite large order to trade with, in the same security and at the same time. The inclusion of smaller orders makes it more likely that an execution will occur. As a result, “dark” trading on MTFs - which only accounts for a small proportion of multilateral volume (e.g. in July 2012 “dark” MTF volume accounted for 4.48% of total volume electronically executed across all Regulated Markets and MTFs in the 15 EU markets in which BATS Chi-X Europe offers trading) - has fulfilled an important need to best serve the requirements of European investors.

A resilient framework for Algorithmic and High Frequency Trading

MiFID II Articles 4, 17.3, 51

The development of automated trading has deepened liquidity and tightened spreads on EU markets. Indeed, the development of automated trading has been necessary to allow the continued provision of risk capital in more competitive and efficient EU equity markets. The use of technology allows investors and firms to manage their risk more closely and, therefore, commit more capital to the markets.

Innovation always presents new challenges for regulators and we support requirements for effective systems and controls. For instance; the recent ESMA guidelines on Automated Trading will help provide the tools required to manage those challenges and so will a more harmonised albeit flexible tick size regime; coordinated circuit breakers will contribute to the better management of some extreme market events; and the market abuse regime and market surveillance obligations on markets and competent authorities provide the tools to tackle potentially abusive behaviour. The operators of

markets are best placed to manage the use of their systems and have a commercial imperative to ensure that the performance of their systems, and therefore the quality of their markets, is not compromised by any particular type of trading or order entry activity.

However a number of proposals currently being considered will not contribute to a more resilient environment. For example, mandating continuous liquidity provision for a particular class of market participants could be discriminatory, and is likely to have the effect of driving liquidity away from central transparent markets as some participants may not be willing or able to meet such obligations. It is also far from optimal to manage the various risks posed by particular types of trading activity through the imposition of hard parameters in primary legislation. For instance the proposed resting period of 500 milliseconds in article 51 of MiFID II is a rudimentary solution, based on no empirical analysis, which could have a number of unintended consequences, including a widening of spreads and an increase in costs to investors, an increase in risk for trading firms and a loss of liquidity in order books. In our view, trading venues are best placed to assess appropriate parameters based on their market model and their systems' capacity. Similarly, trading venues should be left to decide, in conjunction with their lead regulator, the criteria for managing order to trade ratios in their marketplace.

Exchange and MTF fees

MiFID II Article 27, 51.5a EP text

The fees charged by trading venues should be transparent, non-discriminatory and should not incentivise disorderly trading behaviour. However, markets should be free to develop pricing schemes, including discounts and rebates if considered appropriate, that they feel will incentivise desired trading behaviour and reward those firms who enhance market quality through, for example, the provision of passive liquidity on order books or market making programs. It is through the development of new pricing schemes by new entrants that trading fees more generally have been greatly reduced since the implementation of MiFID.

Subject to regulatory oversight by competent authorities, the provision of transparent rebates or discounts should not be considered as an inducement or an impediment to best execution; indeed the availability of a rebate may allow an investment firm to provide better execution by reducing explicit transaction costs, as long as this saving is passed on to the client.

Benefits of an open market architecture to Europe's competitiveness

The need for open access to CCPs and their interoperability

MiFIR Article 28

Currently, the lack of open access to certain CCPs restricts where investors can trade and hold their positions, resulting in higher costs and inefficiencies for these investors. Discriminatory access at the clearing level prevents achievement of a fully integrated EU single market. Vertical silos make competition in derivatives trading extremely difficult for new entrants, resulting in high trading and clearing fees – ultimately making Europe's markets less competitive from a global perspective. Open access to CCPs benefits investors and the economy. In addition, open access to CCPs would contribute to managing systemic risk because if one CCP faced difficulties, the existence of alternative CCPs clearing the same or similar instruments would make it possible to quickly move clearing to an alternative CCP.

Article 28 of MiFIR ought to provide for genuine open-access to CCPs regarding both equities as well as derivatives clearing. For open-access to be genuine, the period of time that a CCP is permitted to decide whether or not to allow access to a trading venue in Article 28 of MiFIR should be as short as reasonably practical in order to avoid stifling product innovation, customer choice and competition

between trading venues. Furthermore, where a request is received from an appropriately authorised and regulated trading venue, access should only be refused on exceptional grounds.

Clearing costs remain a frictional cost borne by investors, potentially restricting EU growth. Enabling open access to CCPs is likely to reduce costs, improve services and allow greater product opportunities for investors. Interoperability in equities clearing, as offered by BATS Chi-X Europe, has gone a long way to reducing clearing costs and reducing the systemic risk from a failure of a CCP. Full interoperability in derivatives clearing may be some way off but a “preferred” clearing model with a default clearer is achievable in the short term if regulatory barriers are avoided in MiFIR.

Benchmarking

MiFIR Article 30/MAR

Many heavily traded products are based upon widely referenced benchmarks that were developed during periods of time when there was a de facto monopoly. While trading has now been liberalised, some venues are able to use historic ownership of these benchmarks, developed under monopoly conditions, to effectively prevent competition in index based products. Allowing open access to index licences under reasonable commercial terms would allow the development of choice for investors and help to drive down costs for investors.

The recent LIBOR controversy has highlighted the need for benchmarks to be based, at least in large part, on actual market transactions. Indeed, many indices and benchmarks do not represent a complete picture of market activity in those instruments since significant volumes and prices on alternative trading venues are often ignored by the incumbent index provider. We would recommend that Section VI in MiFIR and the text in MAR should be amended accordingly to mandate the inclusion of a trading venue’s volumes where it accounts for a market share above a certain percentage - e.g. 5%.

BATS Chi-X Europe is keen to continue to contribute to the development of regulatory policy in the EU to ensure safer and better markets for investors and participants. We are available to engage in further discussion on any of the topics contained in this Position Paper.

Contacts

Mark Hemsley, CEO
mhemsley@bats.com

Adam Eades, Head of Legal and Regulatory Affairs
aeades@bats.com