IOSCO consultation report - Evolution in the Operation, Governance and Business Models of Exchanges: Regulatory Implications and Good Practices

IOSCO seeks feedback on the Evolution of Market Structures and Proposed Good Practices

IOSCO is seeking input from market participants on the major trends and risks observed, and the proposed good practices. Comments on the consultation report should be sent to sdmarkets-team@iosco.org on or before 03 July 2024.

The European Principal Traders Association (FIA EPTA) represents Europe's leading Principal Trading Firms. Our members are independent market makers and providers of liquidity and risk-transfer for markets and end-investors across Europe. FIA EPTA works constructively with policy-makers, regulators and other market stakeholders to ensure efficient, resilient and trusted financial markets in Europe. We welcome the opportunity to respond to this Consultation Report.

1. **Do you agree with the analysis provided and the trends identified in Chapter 2?**

As an opening remark we would like to highlight that although, in the Executive Summary, IOSCO has given the definition of the term "trading venue" that "does not include a single dealer system", within Europe there are registered exchanges/MTFs that operate orderbooks using single dealer systems. We discuss this business model in our response to q2.

We agree with the analysis provided and the trends identified in Chapter 2 for the most part. The trend towards the de-mutualization of exchanges that began in the early 2000s has resulted in most significant exchanges in Europe being for-profit organisations. There has also been substantial consolidation amongst exchanges in Europe arising from acquisitions by other exchanges. Furthermore, there have been acquisitions by exchanges of entities not involved or only peripherally involved in exchange type activities resulting in a significant dilution of the importance of revenues arising from execution fees to the overall revenues of the groups operating these exchanges.

We note IOSCO's reference to the core business of exchanges being "the listing and trading of financial instruments, the provision of certain market data and self-regulatory functions". We believe that the core activities of exchanges should be construed more narrowly than this with the focus being on the listing and trading of financial instruments. The setting and enforcement of trading rules, particularly in relation to ensuring that there is an orderly market, is a key component of facilitating the trading of financial instruments and is subsumed under that heading. The other activities mentioned such as the provision of market data are very much ancillary to these core functions. As pointed out in the consultation report, revenue derived from other functions, in particular market data services, has steadily and, in some cases, significantly increased. We believe this could create a conflict of interest between this increasingly important profit generating function and the required focus on trading i.e., on the fair and efficient functioning of exchanges to help maintain liquidity and facilitate price discovery. We, therefore, believe that narrowing the definition of the core activities would assist with ensuring the provision of market data does not detract from the operation of the exchange.

We note IOSCO's reference to "increased competition" in the exchange space. We agree with IOSCO that there has been increased competition in equity and ETF trading among trading venues in Europe. There is, however, little effective competition and no trend of increased competition in the European exchange traded derivative space, particularly with respect to the trading of index derivatives. We believe that this largely arises from the operation by some exchanges of "multiple business lines" as referred to in Chapter 2, section 2 of the Consultation Report. More specifically, it arises from the operation of 'vertical silos' by some European derivatives exchanges. These 'vertical silos' often include trading, clearing and index trademarking rights within one commercial group. This limits the potential for competition in the trading space as other exchanges wishing to list identical competing products are not granted licences to use the trademark or, if they are offered a licence, the commercial terms may be unreasonable as to render any competitive venture completely unviable. In any event, even if such licences were granted, firms trading these derivatives on the competing exchange would be faced with significant clearing and margin inefficiencies because the exchange would not be able to clear the product in the clearing house owned by the vertically siloed exchange group.

This lack of fungibility across venues results in fragmentation and in increased costs for investors. For example, a recent piece of research carried out by Acuiti in conjunction with Cboe entitled "Optimising European Listed Derivatives Market Structure" noted that volumes for European equity options in 2023 were 798 million down from a high of 1.2 billion in 2012. It further noted, however, that US Equity options recorded a volume of 11.2 billion in 2023 which is an increases of 250% from 2008 levels and more than double the 4.9 billion traded in 2019.[1] Approximately 50% of respondents attributed the decline in volumes in the European listed derivatives markets to fragmentation in the markets, over 30 % of respondents attributed it to lack of competition between exchanges and just under 40% attributed it the costs of trading in Europe[2]. In particular respondents noted that the key areas where costs had "most increased" was in market data and clearing fees paid to exchanges.[3]

If multiple EU exchanges were permitted to clear their listed derivatives through an incumbent (currently siloed) CCP, this would introduce much needed competition into the EU listed derivatives markets. It would allow products to become fungible and introduce significant netting efficiencies as they could be aggregated or offset against each other. Although the MiFID II Level 1 text originally contained an open access provision for non-discriminatory trading venue access to CCPs, its implementation was delayed and, in a disappointing turn of events, removed as part of the recently adopted MiFID II/MiFIR Review process with the following explanation included at recital 31 in the Provisional Agreement Resulting from Interinstitutional Negotiations[4]:

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[1] Optimising European Listed Derivatives Market Structure", Acuiti in conjunction with Cboe, page 3

[2] Optimising European Listed Derivatives Market Structure", Acuiti in conjunction with Cboe, page 6

[3] "Optimising European Listed Derivatives Market Structure", Acuiti in conjunction with Cboe, page 9

[4] AG (europa.eu) p35/148. Note – this recital was not included in the final MiFIR Review text published in the Official Journal: Regulation - EU - 2024/791 - EN - EUR-Lex (europa.eu)

> *(31)* Open access provisions for exchange-traded derivatives ***might*** reduce attractiveness to invest in new products as competitors ***might*** be able to get access without the upfront investment. The application of the open access regime for exchange-traded derivatives, laid down in Article 35 and 36 of Regulation (EU) No 600/2014, ***might*** thus limit ***investment*** in these products, by removing incentives for regulated markets to create new exchange-traded derivatives. It should therefore be laid down that ***the*** regime should not apply to the CCP or trading venue concerned in respect of exchange-traded derivatives, thus fostering innovation and the development of exchange-traded derivatives in the Union.

We believe IOSCO should, also, take note of another overall trend in the European markets- concerning declining liquidity. A recent report by Oliver Wyman- "The Capital Flywheel: European Capital Markets Report[5]" noted that "[l]iquidity of equity markets (as measured by turnover velocity) decreased from 68% to 52 % in Europe, whilst it stayed at 145% in the US over the same time frame"[6]. Clearly, there may be many reasons for this divergence that are unrelated to the structure and regulation of the markets themselves. We would respectfully suggest, however, that IOSCO consider whether the structure and regulation of these markets in Europe accounts for some of this disparity. One obvious difference between the growth in Europe and the US relates to the greater transparency of the US markets and the greater competition between trading venues in the US. We believe that the relative absence of both factors are impediments to growing liquidity in Europe.

We note in particular IOSCO principle 35 in this regard "Regulation should promote transparency of trading"[7] and encourage IOSCO to explore the impact of these transparency differences on the relative quality of markets in Europe and the US. For example, in the US the TRACE regime for corporate bonds and similar reporting regimes, such as the EMMA (Electronic Municipal Market Access) regime for municipal bonds, highlight the benefits of post-trade transparency. Since TRACE was implemented over 20 years ago, several academic papers[8] have been published examining its effectiveness in contributing to more accurate pricing, greater competition amongst liquidity providers and tighter spreads, amongst other consequences. These studies indicate that fully operative and genuine post-trade transparency provides significant advantages for both retail and institutional investors such as better, more reliable pricing, lower transaction costs and better liquidity. This extends even to liquidity in large block trades. However, the European bond markets remain opaque and predominately bilateral with a lengthy deferral regime.

We agree that another trend that has emerged is the use of a common trading platform by multiple exchanges or trading venues belonging to the same Exchange Group/Multinational Exchange Group. In general, we believe this is a beneficial development for market participants

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[5] European-Capital-Market-Report.pdf (fese.eu)

[6] Ibid p3

[7] Objectives and Principles of Securities Regulation, IOSCO, May 2017

[8] Bessembinder, H., et al., "Market transparency, liquidity externalities, and institutional trading costs in corporate bonds" (2006) Journal of Financial Economics

Edwards, A. K., et al., "Corporate bond market transaction costs and transparency" (2007) The Journal of Finance

Goldstein, M. A., et al., "Transparency and liquidity: A controlled experiment on corporate bonds" (2007) Review of Financial Studies

Asquith, P., et al., "The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market" (April 2019)

Jacobsen, S., et al., "Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds" (2018)

as it lowers the barriers to entry. Once a new entrant to the Exchange Group has onboarded to one exchange it will also have seamless access to the other exchanges in the group. However, we question how mergers and acquisitions are handled in a manner consistent with the public interest in the context of impact to existing members, in line with the recommendation in the Consultation Report that regulators consider whether the exchange strategy is implemented inter alia in the interest of the clients they serve.[9] A recent EU exchange acquisition resulted in the requirement for existing exchange members to migrate in phases to a new datacentre, onto the common trading platform and to a different CCP and CSD. Although there was expected to be streamlining benefits, this has yet to come to fruition for existing members with significant migration costs incurred and, also, an increase in ongoing charges at the Exchange Group.

2. Have you identified other major trends regarding the changes in the business models of exchanges?

In IOSCO's 2006 paper "Regulatory Issues Arising from Exchange Evolution- Final Report". IOSCO correctly highlights the importance of the public interest role of exchanges noting in particular that "the fair and efficient functioning of the secondary market is of significant benefit to the public." We are open in principle to either mutual or for-profit ownership structures for exchanges. We note, however, that the requirement to maximise profits for shareholders may have an impact on the exchanges' incentive to act in public interest. For example, it is generally accepted that retail participation in financial markets is a critical component for a well-functioning liquid marketplace as well as being of benefit to the wider economy by channelling investors savings into helping businesses raise money[10]. We believe, however, that many exchanges in Europe consider the current lack of retail participation in the European markets (particularly in the listed derivatives markets) to be a given and do not make material investments in the marketing and education work that is needed to develop this segment of the market. This may be driven by the fact that such an effort would result in an increase in costs for the exchanges in the short term in return for an uncertain long term return and indeed a return that may not be entirely internalised but would nonetheless result in a positive externality for the operation of the public markets as a whole.

Even more perniciously than the above, however, we note some of the small number of exchanges in Europe that do actively court retail flow have adopted a single dealer system, also known as a single market maker model.[11] This involves the active limitation by the exchange of the provision of liquidity to this retail flow on their market to one market maker only. We fail to see how this lack of competition serves the interests of investors. We respectfully request that IOSCO members consider how such market models, regardless of trading venue type, are compatible with the three objectives of securities regulation established by IOSCO which are: protecting investors, ensuring that markets are fair, efficient and transparent and reducing systemic risk.[12] We believe that a single market maker model may compromise best execution, reduce efficiency through lack of competition and result in a single point of failure that may increase systemic risk.

[9] See "Examples of Toolkits" p30.

[10] Bierbaum, H et al., "Widening retail participation in equity markets" (2023) New Financial

[11] More information on this can be found in media articles including "Club rules? How German retail trading venues shut out PTFs", Risk.net.

[12] Objectives and Principles of Securities Regulation, IOSCO, May 2017

Furthermore, the ongoing increases in the price of market data (which must be consumed by members in order to trade on a given exchange) connected to the more diversified business models addressed above, creates an extremely high cost base for participating in these markets. Consequently, it dampens incentives to allocate capital to the markets so affected and in some cases acts as a barrier to entry to new participants ultimately impacting liquidity and capital markets growth.

3. If yes, what other factors do you think might have contributed to the additional trends identified?

Please see the answer to 2 above.

4. Do you agree with the risk and challenges identified in Chapter 3?

We broadly agree with the risks and challenges highlighted in Chapter 3. We note, however, that the multiple regulatory risks arising from the single market maker model adopted by some exchanges are omitted from the list of risks. As noted above, we believe that a single market maker model may compromise best execution, reduce efficiency through lack of competition and also result in a single point of failure that may increase systemic risk. Furthermore, we understand that these models may involve the regulated market entering into a "co-operation agreement" with the single market maker whereby an exchange segment is effectively operated by this market maker.[13] In addition to the risks already highlighted in this paragraph, we would be grateful if IOSCO members could consider whether the conflicts of interest that must be inherent in such a model can be effectively managed. If they cannot be effectively and transparently managed then such arrangements should be prohibited.

5. Do you think there are other risks and challenges that have not been identified?

See above.

6. Do you have comments on the proposed good practices identified in the boxes in Chapter 3?

We have no specific comments, we agree with the proposed good practices identified in the boxes in Chapter 3

7. Do you have suggestions regarding other good practices and/or examples of toolkits to be included?

Please see our answer to 2 and 4 above

[13] Hamburg Stock Exchange: BÖAG Börsen AG and Lang & Schwarz TradeCenter AG & Co. KG extend cooperation for the Lang & Schwarz Exchange – Hamburg Stock Exchange (boerse-hamburg.de)