

Improving Returns for Ordinary Investors: The Importance of the Reference Price Waiver

Sharing the concerns of investors regarding the suggestion of some policymakers to remove the Reference Price Waiver (RPW), this AFME Note explains that the RPW is needed to maintain best execution for investors and does not impact price discovery.

AFME has witnessed a growing concern amongst pension providers and institutional investors that the interests of their beneficiaries may not be best served by some of the proposed changes to market structure under MiFID II/MiFIR. AFME shares these concerns.

Responding to the legislative proposals, the European Federation for Retirement Provision (EFRP)¹ have recently published a paper² which cites concerns that *“some of the elements in the proposals do not take the specific needs and characteristics of pension funds investment policies into account. In their current form, some elements of the MiFID II and MiFIR Proposals could have negative consequences on the financial activities of pension funds.”*

The concerns raised by the EFRP are reflected widely by our Members and their clients who are particularly concerned by the suggestion to remove the RPW. The RPW protects wholesale trades against market impact, providing efficiency and accessibility for investors in the execution of their orders. The RPW is used for only small proportion of trades but these are material in absolute terms. Removing the RPW will increase execution costs and bring no benefit to investors.

In terms of the MiFID Review, we support the Commission’s proposal to regulate Broker Crossing Systems (BCS) as Organised Trading Facilities (OTFs) and to apply the same transparency regime across all regulated venues including the extension of the RPW to apply to OTFs alongside Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs).

We believe that transparency is critical to the efficient functioning of markets but share the IOSCO view that transparency should not be an end in itself but recognise that the *“interest of individual market participants and their customers in transparency levels varies and regulators need to assess the appropriate level of transparency in any particular product market with considerable care.”*³

In the context of calibrating the pre-trade transparency regime, we would encourage policy makers take into due consideration, the views of investment professionals who represent the savings needs of many ordinary citizens. In particular, we suggest that the following points be considered:

- Institutional investors⁴ have consistently advocated the retention of BCS (enabled by the RPW).
- AFME has seen no evidence that retail investors are disadvantaged by BCS given their share of the market. Price formation in equity markets is in good health and we see no immediate threat to the primacy of lit markets. However, we agree with IOSCO on the need for regulators to monitor price formation and to take action if evidence does emerge that it is threatened.
- The RPW benefits institutional investors, increasing their willingness to trade and thus aggregate liquidity, but frustrates some financial intermediaries and incumbent exchanges.
- AFME observes that many of the most vocal advocates of removing the RPW have a primarily commercial (rather than investor) interest in that outcome.

¹ EFRP represents 22 member associations covering the majority of EU States and workplace pensions of 83 million European citizens. EFRP member associations represent ca. €3.5 trillion (at 2009 values) of managed assets for future pension payments.

² EFRP Position Paper on MiFIDII and MiFIR – May 2012 (<http://www.efrp.org/Publications/EFRPLibrary.aspx>)

³ IOSCO Report, Issues Raised by Dark Liquidity, Oct 2010 (www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf)

⁴ For examples of investor support for RPW, see responses to 2010 CESR CP on transparency in equity markets: Fidelity (www.esma.europa.eu/system/files/1-FIL.pdf - q1 and q2), and Wellington (www.esma.europa.eu/system/files/Letter_to_CESR_dated_5_31_10.pdf - cl. 2.1):

The suggested removal of the RPW raises a number of questions as to the need for the RPW and the consequences of its removal. The Note is structured in the form of answers to the following questions:

1. What are the concerns being raised by institutional investors?
2. Why is the RPW relevant to these concerns?
3. Does the RPW benefit institutional investors at the expense of other parties?
4. Does the RPW harm price-discovery?
5. What is the significance of the RPW?
6. What would be the effect of not having the RPW?
7. Are the retail public disadvantaged?
8. Are a sufficient proportion of orders transparent to participants?
9. Do trends suggest that price formation will be damaged in the future?

1. What are the concerns being raised by institutional investors?

Investors are concerned that aspects of proposed changes to the transparency regime, although well intentioned, may be counter-productive for their intended beneficiaries (the majority of which are ordinary citizens). In their position paper, for example, EFRP strongly supports the principle of increasing transparency but expresses concerns over two potential unintended consequences of the proposals; in particular that they may:

1. *"Favour short-term oriented market participants over long-term institutional investors: high-frequency traders and other speculative operators could take undue advantage;"*
2. *"Offer trading venues the opportunity to take undue commercial advantage from pension funds' investment activities. This commercial advantage would not be counterbalanced by any benefit for the trading activity of pension funds, and hence for their members. Therefore, it would only represent an unjustified cost for pension funds, affecting the returns on investments and, ultimately, the contributions paid to workplace pension beneficiaries."*

2. Why is the RPW relevant to these concerns?

The RPW permits a number of execution mechanisms to operate and is effective in removing unnecessary execution costs for institutional investors. For example, so called 'dark pools' operated by MTFs and incumbent exchanges presently rely on the RPW to effect more efficient executions and therefore lower trading costs. Additionally, based on the intentions published in respect of the MiFID Review, any crossing facilities operated by brokers will fall under the same transparency regime and will therefore also need the RPW to maintain a fair and effective service going forward.

Nevertheless, there appears to be significant pressure amongst certain European regulatory and legislative stakeholders to remove the RPW. Arguably, the greatest concern amongst institutional investors is the threat that the removal of the RPW poses to the ability of brokers to match institutional flows efficiently in the interests of their clients.

3. Does the RPW benefit institutional investors at the expense of other parties?

Yes, we believe it does.

Predatory trading is frustrated. Additionally, the valuable providers of liquidity to public markets do so to make a profit from the Bid/Ask spread in a security in return for providing immediate liquidity. When a broker is able to match two pieces of an institutional order at the same reference price, they deny profit to the liquidity provider which would otherwise have to be paid by the

investor. Critically, this saves the investor the expense of paying for a liquidity provision service that they do not need (with the corollary being that the liquidity provider does not receive a fee either).

When a broker matches part of its order flow internally, exchanges and public markets receive fewer fees. Investors also benefit through lower brokerage commissions on the basis, for example, that such commissions are lower than institutional investors would have to pay on exchanges.

4. Does the RPW harm price-discovery?

Efficient price discovery is crucial to all investors. In May 2011, the International Organisation of Securities Commissions (IOSCO) published its final report *Principles for Dark Liquidity*⁵. In this report IOSCO listed the reasons for use of dark pool as:

- *“to minimise information leakage;*
- *to minimise market impact costs;*
- *to facilitate the execution of large blocks which may be difficult to achieve on transparent markets due to a lack of depth in the order book;*
- *to ensure better control of an order;*
- *to protect proprietary trading information;*
- *to manage interaction with algorithms or programs that seek to identify or sniff out dark orders used in transparent markets;*
- *to take advantage of the possibility of price improvement; and*
- *to minimise transaction costs.”*

In their 2010 Transparency Report, IOSCO notes that: *“The interest of individual market participants and their customers in transparency levels varies and regulators need to assess the appropriate level of transparency in any particular product market with considerable care.”*

But AFME also wholeheartedly agrees with IOSCO’s findings that: *“If enough orders are not transparent to participants, or there is unequal or incomplete information about transparent orders, there may be insufficient information about prices for market participants to identify trading opportunities. Because dark orders and dark pools do not contribute to pre-trade price discovery, there may also be concerns about whether they free-ride on the revealed intentions of other participants in the market.”*

We consider that IOSCO thereby raises important questions that deserve to be addressed directly in determining appropriate levels of transparency.

It is therefore important to remember that all trading under the RPW remains post-trade transparent. This further contributes to price formation and should retain investor’s confidence in the markets in which they operate.

5. What is the significance of the RPW?

Pre-trade transparency waivers were designed to reduce the market impact of wholesale trades. The RPW is one of four waivers under which the presumption of pre-trade transparency may be waived on RMs and MTFs under MiFID. The other waivers are the Large in Scale Waiver, the Order Management Facility Waiver and the Negotiated Trade Waiver. Under the MiFID II proposals, pre-

⁵IOSCO: Principles for Dark Liquidity: Final Report: May 2011
(<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD353.pdf>)

trade transparency waivers will need to be included in the regulations under which BCS services will be provided.

The RPW was in particular designed to reduce the market impact of large wholesale orders transacted as smaller child orders. Institutional firms representing retail clients typically trade large orders and leverage BCS, which enable them to get a better result for their clients by reducing market impact and hence costs to trade. It is important to maintain this choice of market structures where firms can vary their interaction with the market in line with their objectives, balancing urgency to execute the order vs. the risk of information leakage to the market. Removing the RPW would have a negative impact on options available to investors.

As outlined above, a broker needs to be able to match the smaller pieces of its client's orders together without first publishing those pieces to the marketplace. It is often crucial that a broker be able to match orders in smaller sizes to meet the trading objectives of the institutional investor. For example, many such investors have institutional or block-sized orders which they need to trade incrementally to achieve best execution for the end investor. The Large in Scale Waiver is accordingly not suitable here: orders are broken down to meet the investors' trading objectives and also to mitigate the risk of execution at a single price point.

Removing the RPW would create the need to pre-trade publish these 'child' portions of an institutional investor's orders to the market. This would make operating such a matching service unviable due to the level of information that could be inferred about the investor's larger 'parent' order, generating considerable signaling risk and thus exposing them to predatory trading practices.

6. What would be the effect of not having the RPW?

The removal of the RPW would undermine the provision of BCS services, increasing execution costs for institutional investors through the following effects:

- **Increased spread costs:** At present, a broker with two opposing institutional orders can automatically match the orders, or parts of them, at the same price. Without this mechanism, the broker is forced to incur spread costs on behalf of both of its clients by accessing a 'lit' order book: The buying client then pays a higher price than the selling client for no good reason.
- **Increased risk of adverse market movement:** Without the facilities that the RPW allows, the broker is forced to publish orders and thus flag their clients' intent to the market. This represents an unnecessary risk and avoidable cost for the investor.
- **Reduced liquidity:** Trade execution is not a zero sum game. The removal of the RPW will not translate to a direct shift of liquidity from such trading practices to the lit markets. Instead it will reduce the willingness of investors to trade and materially reduce aggregate volumes of trading thus limiting liquidity.

These effects will generate additional avoidable costs for collective or institutional investors which will be borne directly by their beneficiaries (i.e. pensioners and savers). For example, if you consider an average spread to be 10 basis points (10 bps or 0.10%) then the cost to each of the unmatched buyer and seller is 5bps, conservatively estimating the cost of increased information leakage at the same 5bps. Adding these together, there is an increase of 10bps; accordingly it can be shown (assuming average rates of reinvestment) that over the course of a 40 year pension fund, this requires the pension fund holder to work an extra year to achieve the same return. We understand that these numbers conform with analysis from other sources that has already been shared with many policy makers.

7. Are the retail public disadvantaged?

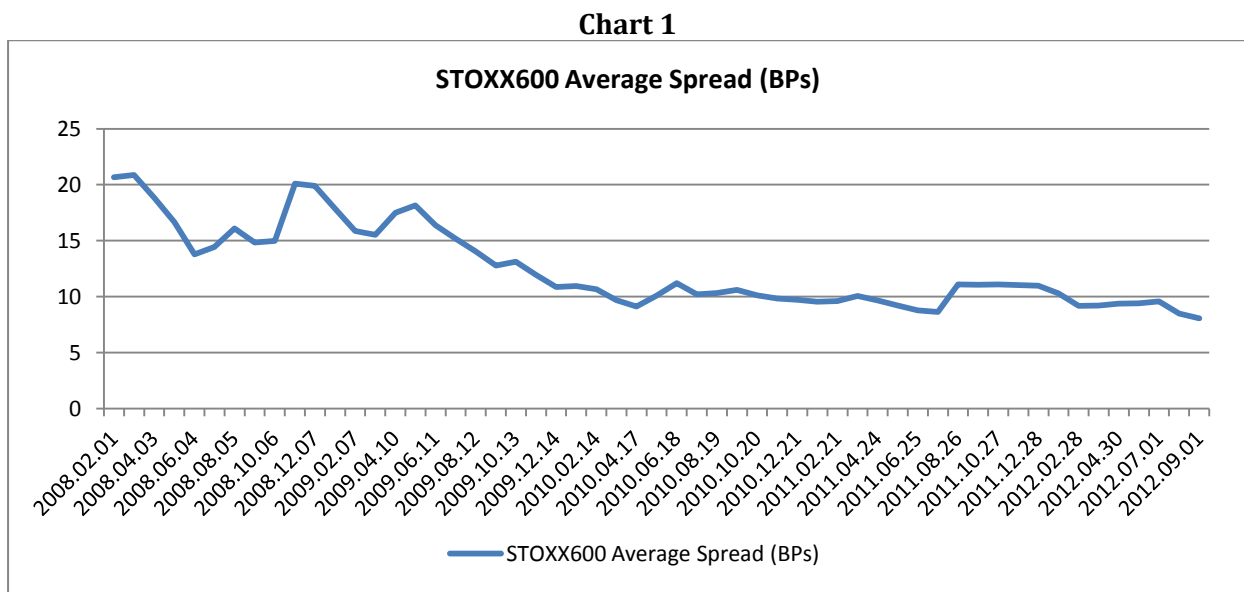
No. The majority of retail investors access the markets via collective investment schemes and are represented collectively by institutional investors. Members of the public accessing the markets directly usually demand immediacy of execution and regulation requires that best execution be provided. BCS in which uncertain execution time is traded for expected price improvement and greater anonymity are of less value to such investors and their far smaller orders.

Retail investors continue, to be served very well by conventional lit markets. Despite the emergence of dark pools and crossing systems, institutional investors continue to execute the overwhelming majority of their business either on conventional order books. This liquidity, in combination with fierce competition between dedicated liquidity providers (and the venues which have sought to attract them), has driven down spreads significantly since the introduction of MiFID. These reduced spreads have translated directly into lower costs for retail investors. This should not, however, be construed as a rationale for the prohibition on dark liquidity; notwithstanding the relative minority presence of dark venues (enabled by the RPW), when operating in tandem in the market with lit venues, they remain a valuable tool for institutional investors (and accordingly the retail investors they serve).

8. Is a sufficient proportion of orders transparent to participants?

We firmly believe so. The overwhelming majority of executions continue to take place on lit order books, despite the passage of multiple years in which dark pools have had the opportunity to compete alongside incumbent lit markets and despite what AFME considers to be repeated inaccurate suggestions to the contrary. The successful duality of lit and dark venues evidences that a balance is possible between transparency and liquidity, offering choice to market participants, depending on their execution needs.

The reduction in average spreads witnessed over the period over which dark pools and crossing systems have evolved, supports our assertion that the price formation process continues to operate very effectively despite current market conditions. The data in Chart 1 below demonstrates this.



Source data : Thomson Reuters (compiled by JP Morgan)

9. Do trends suggest that price formation will be damaged in the future?

Trends of Lit, Dark and BCS Market Share do not suggest that price formation will be damaged in the future.

- The current portion of European equity market trading that is conducted via the RPW is less than 4%. (Dark MTFs can be used as a proxy for the RPW).
- In a MiFID II context, by including the trading activity taking place in BCSs (which exist today but do not require the RPW), this total figure is likely to rise to just under 8%.

Chart 2 and Table 1 below illustrate the trend of lit, dark and BCS market share since July 2010. AFME does not expect the portion of dark trading to continue rising substantially in the future. In the US for example, the portion of dark trading has stabilised to around 12% over the last few years.

Chart 2:

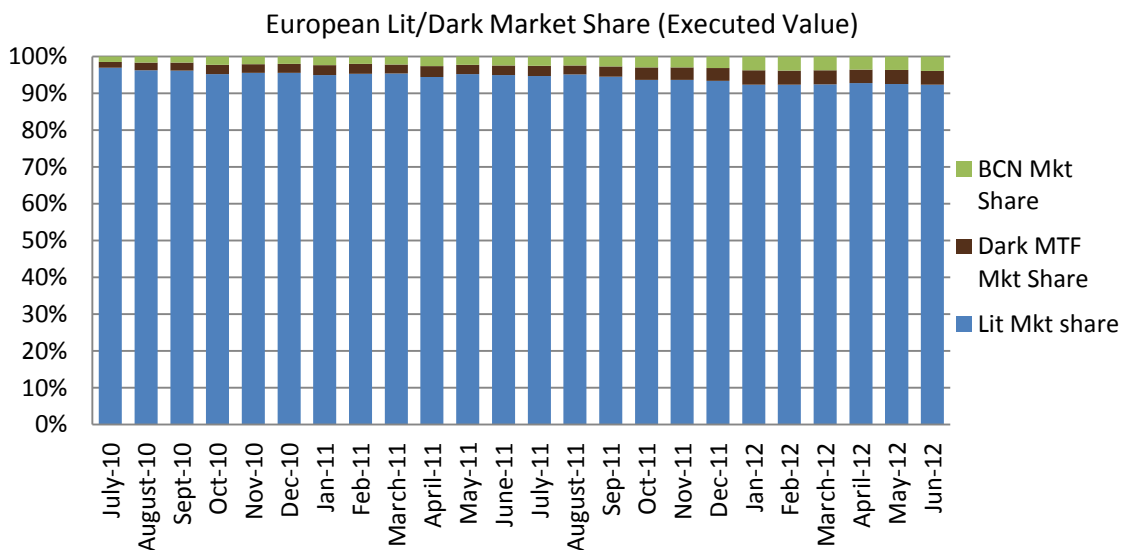


Table 1:

Time Period	Dark MTF - Average Monthly Value traded (EURm)	BCS - Average Monthly Value Traded (EURm)	Lit - Average Monthly Value Traded (EURm)	Reference Price Trading as a % of total turnover*
July 2010 - December 2010	15,547	13,520	690,067	4.04%
January 2011 - June 2011	22,561	19,598	813,449	4.96%
July 2011 - December 2011	24,765	23,031	793,786	5.79%
January 2012 - June 2012	28,565	28,209	697,250	7.53%

Sources: Dark MTF, and Lit (RM, MTF) Notionals: *BATS-CHI-X*. Dark BCN Notionals: *Markit*
 *Market share calculation is calculated as (Dark MTF Notional + BCN Notional) / (Dark MTF Notional + BCN Notional + Lit Notional)

Please note that:

- Non-BCS OTC data has been deliberately excluded from the analysis, both because it represents traditional bilateral trading that will not be impacted by the RPW and because of the problems inherent in the MiFID rules with interpreting this data.
- We estimate there to be approximately an additional 10% of this OTC real liquidity available. In 2010, AFME calculated there to be 2% accounted for by SI, 6% by broker to broker (non give in/up) and 2% by other agency and riskless principal. Please refer to AFME's report 'The Nature and Scale of OTC Equity Trading in Europe'⁶ for further information
- Dark MTF Market Share includes all pre-trade transparency waivers (of which RPW is a subset)
- BCN Market Share – pre-trade transparency waiver not (currently) required

Conclusion

Investors and AFME Members are very concerned by the suggested removal of the RPW. The RPW is critical to ensuring best execution for investors and that its removal would have a materially detrimental impact on investor returns. Whilst we believe that its use should be subject to regulatory monitoring, the RPW is a legitimate and longstanding policy instrument that achieves the appropriate balance between transparency and liquidity and it has to date had no negative impact on the price formation process.

⁶The Nature and Scale of OTC Equity Trading in Europe, AFME, April 2011
<http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=5261>