London Stock Exchange Group

UnaVista

Turquoise London Stock Exchange Group

Trading in Europe from a US perspective

Introduction

Many US firms want to trade in Europe's financial markets. However, proposed regulatory changes and the impact of technology and competition on trading, reporting and clearing mean that US firms need to be well prepared to get the most from Europe's opportunities.

In this paper, London Stock Exchange Group (LSEG) and Turquoise look at how the landscape is changing and the ways in which we can support US firms who trade in Europe. Turquoise is majority owned by LSEG and part owned by 12 leading global investment banks.

Europe’s Evolving Regulations

MiFID’s introduction in November 2007 led to dramatic changes in European cash equity markets. Removing concentration rules allowed new entrants such as Turquoise to compete head on with the traditional exchanges. This, along with improved technology, led to faster and cheaper ways to trade, and presented significant opportunities for firms that could replicate arbitrage and other high-volume, low-margin trading strategies across multiple venues.

The growth in high-frequency trading (HFT) post-MiFID has been substantial, and has led to the atomisation of public limit order books across Europe. Market fragmentation and algorithmic trading have compounded this effect, with smart order routers slicing and dicing orders into ever-smaller sizes to capture liquidity while minimising market impact. For example, the average order on LSEG’s SETS order book is one-third its pre-MiFID size.

Ironically, as price formation has become faster and more efficient and liquidity has increased, traditional brokers have been less able to commit capital against institutional block orders, and demand has therefore grown for ‘dark’ pools. Dark volumes remain a small part of the overall volumes traded in Europe, but US and continental-European exchanges have raised concerns that too much internalisation might undermine efficient price discovery, by depriving lit markets of retail and other non-directional flow.

These concerns have led to growing regulatory, and now political, pressure. The European Commission’s proposals following the MiFID review, now due after the summer are likely to increase regulation for algorithmic trading and HFT. In particular, proprietary trading firms will, at some level, have to be authorised as an investment firm, and will in any event come under greater scrutiny.

Questions were asked about mandating minimum order/trade ratios, or minimum resting times for orders. Most practitioners and regulators, however, seem to recognise that these approaches are impractical and would probably reduce liquidity and widen spreads. Also market making obligations would not apply in a “fast market”. Whatever the outcome, it is likely that the MiFID proposals will cause further significant changes in Europe’s financial markets.

Turquoise and LSEG have argued for an evidence-based approach to regulation, noting that HFT’s detractors have presented scant evidence that it reduces market quality. To counter accusations of providing phantom or ephemeral liquidity, we believe regulators should tighten pre-trade risk controls at market centres, to ensure that trades will not be arbitrarily cancelled after periods of price volatility. Firms will then be more likely to continue providing liquidity, when others cannot.

It is true, however, that fragmentation and atomisation have increased market data volumes, straining the infrastructure of data vendors and consumers. Given that information technology has relentlessly driven down trading costs, we are cautious about regulation to artificially control legitimate market activity. We would prefer to see that energy devoted to detecting and eliminating market abuse however arising. The European Commission also plans to review the Market Abuse Directive at the same time.

Perhaps more interestingly, for Europe and for Turquoise, the new proposals will bring derivatives within the scope of MiFID. A lack of competition in this space has seen trading fees seven-times higher than in cash equities and, arguably, the absence of innovation has stymied growth. The Commission aims to increase competition by encouraging all trading in sufficiently liquid derivatives, which are eligible for clearing, to move on-screen to lit markets.

Increased competition should, as we saw post-MiFID in cash equities, lead to cheaper and faster ways to trade, providing new trading opportunities across the market. A number of challenges need to be addressed to make this happen, particularly the lack of fungibility and competitive clearing, and we look to the regulators to lower those barriers as quickly as possible.

Turquoise is part of that change. With our recent launch of FTSE 100 Futures and a number of other products in the pipeline, we are looking to build a truly competitive pan-European equity derivatives platform. We will do this by creating an open and competitive market structure and by dramatically reducing trading and clearing tariffs. This should increase on-screen liquidity, enable growth in electronic execution and algorithmic trading, and provide new trading opportunities for our clients. We are also working with other potential new entrants to create a more efficient post-trade model.

The Growing Importance of Equity Swaps

Equity swaps are increasingly important in Europe and trading volumes are growing, particularly by hedge funds. They offer a more flexible trading approach, primarily by allowing trading on margin, which frees capital for other uses. In some jurisdictions they can be tax efficient, although for US traders the HIRE act may reduce these benefits. In others, such as some Middle-Eastern exchanges, they provide exposure to markets where local restrictions make it hard to directly participate.

Typically, there are three main participants in an equity swap: the buy-side firm placing the trade; the prime broker who writes the swap; and an executing broker who hedges the contract by providing the underlying security.
Following Lehman Brothers' collapse, many hedge funds spread their business across several prime brokers, to mitigate risk.

A number of problems arise in processing these trades. Automation is patchy, with some prime brokers relying on manual labour and some executing brokers using emails to send details of give-ups. The length of time it takes to manually handle this data means that most exceptions are only resolved on T+1. In addition, hedge funds using multiple prime brokers must maintain separate connections to each one and view results in different interfaces, which is inefficient.

There is also uncertainty around potential regulatory requirements for reporting and centralised clearing of equity swaps. Both reporting and central clearing require a level of standardisation that does not exist today. A possible trade-off may be that non-standard instruments will carry more onerous reporting requirements than standardised ones that are traded on an exchange and cleared by a central counterparty.

One way of mitigating these issues is to use a central system to communicate and match trades across counterparties, such as LSEG's UnaVista system. UnaVista is hosted by a trusted, neutral venue, and has a data model which is effectively infinitely extensible, allowing multiple forms of integration suitable for any type of counterparty. As a result, it enables hedge funds, prime and executing brokers to significantly increase their processing efficiency for equity swaps and additional instruments, resolve exceptions on T, and ensure they are prepared for whatever regulatory challenges lie ahead.

Reducing the Cost of Transaction Reporting

Transaction reporting in the US is at least as onerous as the obligations imposed by MiFID. For US algorithmic and HFT firms setting up in Europe, connecting to the national regulatory bodies is a minor technical headache which will not affect their tight margins.

The UK is a different story. The FSA has unilaterally imposed a system of reporting via Approved Reporting Mechanisms (ARMs), which validate and standardise data from hundreds of firms before it is sent to the FSA. Under MiFID, Electronic Trading Participants (ETPs) were able to exploit a loophole excluding firms that only executed proprietary trades, but this is likely to be closed under the revised MiFID.

Using ARMs reduces the FSA's burden, allowing it to concentrate on analysing the data for market abuse, while the ARMs charge reporting firms for the service. Where an ARM provides additional services, such as data mapping, detailed management information reports and data reconciliation, these charges can be justified. However, many ETPs see these charges as a tax with no benefit to them, since electronic trading uses pre-determined algorithms and is outside the realms of insider information.

In fact, ETPs should recognise that they benefit from a well-regulated and orderly market. Writing trading algorithms is easier if the market is not skewed by a minority who trade on illicit information. Furthermore, the ARM regime is becoming increasingly competitive, with many throwing away their one-size-fits-all price lists and tailoring both their services and pricing to their clients' requirements. UnaVista Transaction Reporting is a good example, having recently introduced a new ETP product and pricing model that takes high-volume trading strategies into account. The result is more cost-effective reporting and greater profitability for clients.

A Trusted Partner

Changes in European regulations and the evolution of trading, clearing and reporting mean that US firms can benefit from having a trusted partner to guide them. LSEG and Turquoise provide the full range of advice and services that US firms will need, and the expertise and knowledge to help them succeed.

Turquoise

Turquoise is a market leading Multilateral Trading Facility (MTF) giving customers access to pan-European and US lit and dark equity trading in more than 2,000 global securities. Unique functionality in Turquoise's Integrated Book combines visible and non-displayed orders to deliver increased likelihood of execution and price improvement.
Turquoise's Midpoint Book is an entirely non-displayed execution service, where trades execute at the midpoint of the bid-ask spread. Turquoise also operates TQ Lens, a non-displayed liquidity routing service, which offers clients access to the otherwise inaccessible internal crossing networks of their peers. Turquoise has been majority owned by the international diversified exchange business,
London Stock Exchange Group, since February 2010.

London Stock Exchange Group: UnaVista

London Stock Exchange Group sits at the heart of the world's financial community. The Exchange is a trusted, neutral and regulated company that is uniquely positioned to provide solutions that address industry wide challenges.

UnaVista is the London Stock Exchange's secure hosted platform for all matching, validation and reconciliation needs. It is a technologically advanced service that offers clients a range of business solutions designed to help businesses become more efficient and more profitable whilst reducing their risk. UnaVista has a number of offerings that include Transaction Reporting, Confirmations Portal, Swaps Portal, Reconciliations as well as reference data services.

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