Knight

Knight Capital Europe Limited
Response to CESR/ 10-142
Submitted before the
Committee of European Securities Regulators (CESR)
Call for Evidence on
"Micro-structural issues of the European equity markets."

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Knight Capital Europe Limited (KCEL) is pleased submit this response to CESR's Call for Evidence relating to the micro-structural issues of the European Equity Markets.

Background

Knight Capital Group, Inc. (Knight) opened for business in 1995[1]. Built on the idea that the self-directed retail investor would desire a better, faster and more reliable way to access the market, Knight began offering execution services to discount brokers. Today, Knight services some of the world's largest institutions and financial services firms, providing superior trade executions in a cost effective way for a wide spectrum of clients in multiple asset classes, including: equities (domestic and foreign securities), fixed income securities, derivatives, and currencies.

Knight Capital Europe Limited (KCEL), a wholly owned subsidiary of Knight, opened for business in 1998. Today KCEL provides high-quality, client focused trade execution and sales trading services to more than 700 European clients. Through our network of local brokers, extensive exchange memberships and market access solutions, our clients can access KCEL's full range of voice trade execution services. KCEL is listed as top broker for ADR securities, Exchange Traded Funds (ETFs), U.S Listed Securities, and top NASDAQ – GM, CM and GSM securities brokers. KCEL also provides a direct market access solution and algorithmic trading on its broker-neutral electronic trading platform. KCEL's market making business provides liquidity to nearly all of the equity trading venues in Europe as well as a large number of institutional and retail broker dealer clients through our Knight Link platform. Additionally, we are a top three Retail Service Provider (RSP) in the UK, making markets in a wide range of London Stock Exchange (LSE) listed securities. KCEL's fixed income division provides research and trade execution in high-yield and high-grade corporate bonds as well as distressed asset-backed securities, convertible bonds and bank loans. Our currency ECN, Hotspot, provides clients with complete anonymity and increased control over FX trade executions.

Knight has spent the last fifteen years building its technology infrastructure so that it can process millions of trades a day on behalf of retail and institutional investors – in a fast, reliable, cost effective manner, while providing superior execution quality and service. Knight spends tens of millions of dollars every year, making its technology platform better, faster and more reliable. Knight's data centres are some of the most reliable in the industry. Today, Knight has the capacity in the US to

[1] Knight, through its subsidiaries, is a major liquidity center for U.S. and international equities, fixed income securities, and currencies. On active days, Knight can execute in excess of five million trades, with volume exceeding ten billion shares. Knight's clients include more than 3,000 broker-dealers and institutional clients. Currently, Knight employs more than 1,100 people worldwide. KCEL is authorised and regulated by the Financial Services Authority. On 12 May 2010, Knight announced that it will move its NASDAQ listing to the NYSE in the U.S. and cross-list on the Paris segment of NYSE Euronext on 25 May 2010. For more information, please visit: www.knight.com.

process nearly 20 million trades per day, with connectivity to nearly every source of liquidity in the global equities market, and trade response times that are now measured in milliseconds. Years of research and development, technology platform enhancements, and connectivity to liquidity wherever it resides is all brought to bear with a single purpose in mind: securing the highest execution quality on behalf of Knight's customers (and, in turn, their customer – the retail investor).

Accompanying Documentation

Knight recently commissioned an independent, academic study designed to examine various changes to the structure of the U.S. equities market in recent years and the impact on investors. The study was completed by three leading academics, all with extensive backgrounds in equity market structure. The three professors, James Angel (Georgetown University), Larry Harris (University of Southern California), Chester Spatt (Carnegie Mellon University), looked at these changes and the measurable dimensions of market quality. Through empirical analysis, the study shows how innovative trading systems such as dark pools, flash orders, and internalization have benefited public investors and ultimately enhanced the capital formation process in the U.S. These innovations have permitted investors to do what they did before, only faster and cheaper. The study demonstrates that today's investors enjoy more liquidity, faster executions, lower commissions, and tighter spreads than ever before. The study also makes some suggestions for market improvements.

The study, Equity Trading in the 21st Century, was released publicly on 23 February 2010 and we have enclosed a copy for your reference. We have also enclosed Knight's comment letter in response to the recent SEC Concept Release. Both of these papers address many issues covered by the CESR Call for Evidence, but from a U.S. perspective, including fee structure, tick size, co-location, sponsored access and high frequency trading.

Additional Comments

There is a broad swath of firms that are loosely categorised as high frequency traders (HFT). This spectrum includes, among other trading firms and market making firms such as KCEL. KCEL is an electronic market maker adding significant liquidity and price improvement to the European market. Generally speaking, KCEL employs computer models to provide liquidity to incoming retail and institutional order flow. Unfortunately, European retail investors do not benefit from the many advantages that their U.S. counterparts enjoy. Allow us to explain.

In most cases, Continental retail flow is only directed to the primary markets, despite the significant liquidity (contributed by HFTs and other trading firms which often leads to better prices than those available on the primary market) available on multi-lateral trading facilities (MTFs). Furthermore, the UK retail flow executes "off-exchange", without being subject to quality of execution standards and pre-trade transparency. Thus the retail community in Europe does not benefit from better price discovery and improvement, or interact with deeper liquidity that HFTs are able to provide.

In sum, European retail brokers are missing out on significant liquidity, as well as better prices on MTFs and electronic market making liquidity provided through systematic internalisation and other models. Knight respectfully submits that this should be addressed as a matter of priority in CESR's review.

I. High frequency trading (HFT)

1. Please describe trading strategies used by high frequency traders and provide examples of how they are implemented.

Since the trading strategies used by HFT firms are too broad in range to capture effectively, we will not comment on them here. There is considerable debate on the types of trading that make up HFT. In Knight's opinion, in the broadest terms, HFT can be divided into two categories: (i) statistical arbitrage -- where firms look to bring pricing that has become misaligned back into alignment; and, (ii) electronic market making -- where firms are generally taking the other side of trades entering the market. Of the numerous trading strategies engaged by HFT firms, the following appear to be the most common:

- passive vs. aggressive trading (based on the so-called 'maker-taker' model)
- market microstructure
- volatility forecasting
- liquidity modeling

Each in essence analyses public tick-by-tick data and makes buy or sell decisions based on such analysis. Because of the technology employed in this decision making process, trading decisions could occur in milliseconds.

Question 2: no comment.

3. What are the key drivers of HFT, and (if any) limitations to the growth of HFT?

The growth in HFT is primarily driven by opportunity, the desire for more efficient trading models and reward.

- Opportunities arise through technology development and market structure changes. Technology has give market participants the ability to analyse vast amounts of data which enable quantitative analysts to build predictive trading models. The evolution of market structure has created an environment where HFT firms provide crucial liquidity and cost structures are such that HFT firms can trade profitably.

- Efficiency improves client service and execution quality, and reducing costs. HFT firms have used technology to improve their client offerings through auto-execution and request for quote services and have reduced costs by introducing efficiency and less manual intervention into the trading process.

- HFT firms combine their trading expertise, technology capabilities, risk appetite and willingness to commit capital to generate revenue through proprietary trading and/or client focused facilitation businesses.

HFT has grown very quickly. In the US markets, HFT is believed to account for a significant proportion of market volume (by some accounts, as much as 61% of daily US equity share volume

and 70% of daily total trades are attributable to some form of HFT activity[2]). In Europe, it is smaller than the US, but growing. The key limitations that we believe will inhibit the growth of HFT in Europe are as follows:

- Market-wide capacity: will Regulated Markets and other trading venues have enough capacity to handle fast increasing message traffic and trading volumes without creating unacceptable systemic risk?

- The costs of trading, clearing and settlement: HFT firms work on very low margins and the costs of fragmented clearing and settlement in Europe are a major impediment to growth.

4. In your view, what is the impact of high frequency trading on the market, particularly in relation to: - market structure (e.g. tick sizes); - liquidity, turnover, bid-offer spreads, market depth; - volatility and price formation; - efficiency and orderliness of the market?

Please provide evidence supporting your views on the impact of HFT on the market.

The pace of market evolution has been drastic in recent years. It is difficult to separate the impact of HFT from other drivers of change. HFT has been a significant factor in market change, and the result has been some significant benefits to end customers in equity markets.

Quite simply, investors of all types and sizes have benefited greatly by these and other trading innovations.[3] Spreads have tightened considerably, execution costs have reduced and execution speed has significantly improved.[4] HFT has been a major contributor to all of these market improvements. Looking at some of the market changes in more detail, we have seen the following:

- Tick sizes have reduced and spreads have tightened

- Significantly greater liquidity is now available on alternative execution venues to the Primary Markets. As HFT firms primarily trade away from the Primary markets, generally on MTFs and, where appropriate, Dark pools, this has driven a significant increase in liquidity away from the Primary Markets and introduced significant new liquidity to European Capital markets as a whole.

- Better, more efficient markets.

- Faster trading market place: as response to HFT, trading venues are treating latency with higher priority than before, thus benefitting the whole market place.

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[2] Tabb Group, LLC - letter of submission to US Securities and Exchange Commission, December 8, 2009

[3] Although retail investors have been the primary beneficiaries of these innovations, as noted above, their orders are not always exposed sufficiently across multiple market venues and therefore do not always get access to the best prices available.

[4] We have based these observations on the observations noted in Equity Trading in the 21st Century, written by James J. Angel, Lawrence E. Harris, and Chester S. Spatt. Notwithstanding the US focus of the report, many of the same benefits can be seen in the European market.

- Growth of dark pools: Dark pools have developed as an automated solution to the market requirement for low impact block trading and execution rates have increased as HFTs act as liquidity providers in Dark Pools.

- Trading and clearing costs have fallen in terms of unit price.

5. What are the key benefits from HFT? Do these benefits exist for all HFT trading strategies?

Key benefits

- Decreased trading costs

- Narrowed bid-offer spread

- Increased price discovery

- Dampened Volatility

- Streamlined liquidity and timing mismatches

However, there are additional benefits which have not yet taken hold in the European markets. In the US, retail brokers are able to interact with electronic market making flow, thus allowing them to benefit from lower trading costs, and providing the retail brokers with access to information that they were not exposed to before. This has not yet translated to the European retail broking market, and indeed will not until such time as brokers are required, indeed permitted[5], to expose their orders to all accessible liquidity available in Europe.

6. Do you consider that HFT poses a risk to markets (e.g. from an operational or systemic perspective)? In your view, are these risks adequately mitigated?

After the US market disruption on the 6 May 2010, HFT was widely criticized in the media for causing the fall-out. While much analysis needs to be performed to determine the all the factors that created the market swoon, should the market becomes too volatile, or too fast, HFTs will often step back to ensure that they do not compound the issue.[6] Indeed, all data points strongly support the conclusion that HFT does not increase volatility, it actually dampens it.

It would be unlikely that we would see a similar situation here in Europe, as exchanges here have instituted a number of preventive measures including Volatility Auctions (UK and Germany), and Collars(Euronext markets). This would alleviate an incident similar to what occurred in the US on the 6 May. In addition, the US is exploring the use of individual equity circuit breakers as a means of avoiding future micro-panics.

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[5] Article 21 of the Markets in Financial Instruments Directive requires order flow handlers to obtain express consent when executing client orders away from a Regulated Market or MTF. We believe this restriction should be removed as this has created an administrative burden which many retail brokers have chosen to avoid; thereby preventing access to significant market liquidity offered by Systematic Internalisers.

[6] http://online.wsj.com/article/SB10001424052748703686304575228721439480374.html?KEYWORDS=SCOTT+PATTERSON

All types of trading pose a potential risk to the market if not conducted appropriately or adequately monitored. From a regulatory perspective, HFT or human based trading can be used to game or mislead certain market segments, but market abuse is market abuse regardless of whether it was perpetrated by a human trader or a trading algorithm. Anyone who breaks these rules should be held strictly accountable.

From an operational and systemic perspective, HFT does contribute to new challenges for market operators which, if not appropriately managed, could translate into risk:

- Huge message volumes create systemic risk; including the risk that market infrastructure is unable to handle such volumes, and fails. The operators of Regulated Markets and MTFs must be required to continually invest in technology with significant capacity to accommodate growth and market spikes.

- A rogue trading strategy or algorithm has the potential to create market risk by sending high volumes and/or erroneous order messages to a market, thereby distorting the value of a stock, sector or market as a whole. It is important that the users of automated trading systems implement effective systems and controls to manage such risk through testing, monitoring and oversight activities.

7. Overall, do you consider HFT to be beneficial or detrimental to the markets? Please elaborate.

In the end, HFTs are beneficial to the markets. Adding new liquidity and driving trading costs lower are amongst the consequential benefits we have referred to in this paper. However, as noted above, retail investors will not reap the full benefits of the market until they have access all accessible liquidity, including HFT flow.

8. How do you see HFT developing in Europe?

High post-trade costs in Europe will limit rapid growth. However, we hope and expect that industry led solutions such as clearing interoperability and the Target 2 Securities initiative to deliver a single pan-European settlement platform will deliver significant improvements in post-trade costs and facilitate growth. Also, with regulatory support, we believe that HFT/ Electronic market making can grow in the retail environment, with the benefit of approved liquidity access and execution quality reaching retail investors.

9. Do you consider that additional regulation may be desirable in relation to HF trading/ traders? If so, what kind of regulation would be suitable to address which risks?

We do not believe that new regulation is necessary in relation to HFT. However, we do support fully efforts to improve surveillance of the markets and the rigorous enforcement of existing rules designed to address improper trading activities.

II. Sponsored access

KCEL is does not use or provide Sponsored Access. Therefore, we offer no comments in this regard.

III. Co-location

1. What are the benefits of co-location services for organised trading platforms, trading participants and clients/investors?

Communications latencies are due to time lost as messages travel at *the speed of light* and to delays caused by passing messages through routers. To speed their communications, firms can co-locate their servers as close as possible to the exchange servers that produce market information and collect orders.[7]

Co-location in the pre-electronic age was the floor based specialist; today, co-location is the modern replication of that practice. Co-location is what the market desires, for a number of reasons, and a consequence is that the end investor is getting quicker and better executions than ever before. Co-location allows for this in a common environment and by way of a level playing field, not to mention offering economies of scale and cost.

Any act by regulators impeding co-location would only disadvantage market participants by raising transaction costs. Furthermore, it would driver market participants to revert to locating brokerage firms near exchanges as described below, inflating the cost of real estate in close proximity to exchanges, and thus barring those participants who cannot commit the required capital cost of these increases in real estate prices. Co-Location has in fact evened the playing field in this respect.

2. Are there any downsides arising from the provision of co-location services? If yes, please describe them.

Co-location increases dependency on certain infrastructure operators and increases systemic risk by locating large amounts of liquidity generating trading systems in one location. However, these risks are well managed through disaster recovery plans and the benefits of co-location far outweigh any threats. Co-location allows for lower latency and is available to all market participants. The benefits can be shared by all. Firms can invest in co-location to reduce latency or choose an execution broker that has co-located and leverage their investment. This means that co-location is effectively available to all and allows market participants to provide clients with low-latency execution services.

3. What impact do co-location services have on trading platforms, participants, and the wider market?

The introduction of co-location has meant that trading platforms have to keep abreast of the latest technologies to ensure that they keep focus on providing the lowest latency they can offer on their platforms. This has benefitted participants and the wider market as platforms race to offer cheaper and lower latency services.

4. Does the latency benefit for firms using co-location services create any issues for the fairness and efficiency of markets?

[7] Equity Trading in the 21st Century, written by James J. Angel, Lawrence E. Harris, Chester S. Spatt.

Co-location is no different than the traditional practice of locating brokerage firms close to the stock exchange to reduce the time and expense of filling an order. If the practice of co-location were banned, traders would merely seek to locate their servers in the closest piece of real estate to the exchange data centers, with far less oversight than is possible within the exchange data centers.

KCEL sees no disadvantage caused by allowing market participants to co-locate. It is available to all who wish to invest in co-location.

5. In your view, do co-location services create an issue with the MiFID obligations on trading platforms to provide for fair access?

No. Please see response to question 4.

6. Do you see a need for regulatory action regarding any participants involved in co-location, i.e. firms using this service, markets providing the service and IT providers? Please elaborate.

We do not believe that new regulation is necessary in relation to co-location. It is incumbent upon regulated users of such services to conduct appropriate due diligence and risk assessment, and providers to provide fair access.

IV. Fee structure

No comment.

V. Tick size

No comment.

VI. Indications of Interest (IOIs)

1. Please provide further information on how IOIs are currently used in European markets by investment firms, MTFs and RMs?

There are two key uses of IOIs:

- Traditional use: Brokerage firms represent client buy or sell interests with a view to identifying un-displayed liquidity.[8]
- Dealer use: Streaming IOIs: liquidity provision firms update clients and liquidity partners on proprietary buy or sell interests, often on a millisecond basis.

[8] IOIs serve as a valuable method for market participants to communicate with each other. By using IOIs effectively, market participants are able to source valuable liquidity on behalf of investors -- liquidity that may not have otherwise been available in the marketplace.
http://www.knight.com/newsRoom/pdfs/rcl_20091028.pdf

2. Which are the key benefits/downsides of such IOIs? Please provide evidence to support your views.

In general, IOIs serve an important purpose. They are one of the many tools that market participants can use to effectively, inexpensively and quietly source liquidity. They allow for better price discovery, more size to be offered and in turn allow for lower transaction costs for retail and institutional investors alike. They also allow orders of all sizes (large and small) to transact with a minimum of information leakage.

3. Do you consider that MiFID should be amended to clarify that actionable IOIs should be subject to pre-trade transparency requirements?

Pre-trade transparency requirements would simply cause many IOIs to disappear from the market. If market participants wanted to display their trading interest, they could do it today. It is precisely because they are seeking anonymity, that they do not display their IOIs. If it is forced by regulatory fiat, those very same firms using them today will cease to use them. Such an action will undoubtedly result in less overall liquidity in the market.

Many alternative trading platforms have systems for disseminating actionable IOIs to trustworthy entities.[9] These actionable IOIs inform the entity of a trading interest.[10] These are less risky than firm quotes sent to all traders as they are only sent to trustworthy sources.

Actionable IOI is a widely used term; however KCEL submits that the very term is an oxymoron in itself. The term actionable suggests that the IOI is firm; however, IOIs are typically not firm.[11]

For the reasons listed below KCEL strongly discourages an amendment of MiFID bringing so-called "actionable IOIs" within the scope of pre-trade transparency rules:

a. IOIs are often represented as quotes in the market

   Whilst IOIs are offered to specific market participants, the volumes are often seen in quotes elsewhere via quotes on lit order books. Therefore, it is often the case that the wider market has an opportunity to access that same liquidity via a market quote (and if the market quote is filled first, then the IOI is typically pulled). The difference here is that investors get the opportunity to trade at a lower cost.

   Further, because the IOIs many times reflect principal positions, market participants should have the prerogative to trade with counterparts who they believe will use them appropriately.

[9] Knight filed a comment letter in the US with the SEC relating expressly to actionable IOIs. Please see: http://www.sec.gov/comments/s7-27-09/s72709-68.pdf

[10] Equity Trading in the 21st Century, written by James J. Angel, Lawrence E. Harris, Chester S. Spatt.

[11] An important factor in determining the actionability of an IOI is fulfillment rates. Thus, is there a threshold percentage, above which, the IOI would be considered more quote like?

b. Loss of Liquidity

IOIs are used by many liquidity providers or electronic market making firms that are large sources of liquidity to the European market, thus a loss of such actionable IOIs, by an introduction of pre-trade transparency rules, would not necessarily be translated to higher liquidity in quotes – thus, as noted above, liquidity will be lost in the market.

Taking the example of the buy-side broker trading big block orders; the trader is happy to send out an IOI as it merely represents an indication, and is a good tool to source more liquidity for their underlying clients. However, impose pre-trade transparency requirements and that same trader would be less likely to use this tool to source liquidity for fear of information leakage in his large block order. For the same fears, the trader will not post a quote.

Finally, any action to decrease the use of actionable IOIs could increase volatility, thus propelling the market into more uncertain regime.

c. End users will be disadvantaged

Liquidity providers and electronic market making (as a sub-set of HFT) firms' use of IOIs help clients achieve:

- higher fulfillment rates
- lower latency
- lower transactional costs

d. IOIs merely represent an electronic method of traditional broking techniques

Dealers also use actionable IOIs to publish their willingness to fill such brokers' client orders. The actionable IOI allows the dealer to advise the broker that liquidity is available so that the broker can quickly route to it if it represents the best available trading opportunity.

Indeed, allowing sell-side firms to seek out undisplayed liquidity is no different than sales traders looking on Bloomberg at the major holders of a stock and calling them to see if they have an interest in the volumes that they have on offer. With actionable IOIs this is accomplished with a minimum of information leakage. Importantly, post-trade reporting requirements ensure that all traders share in the information produced in trades arising from actionable IOIs.

e. All market participants could have access to IOIs if they so wished

Whilst actionable IOIs are typically sent to specific market participants, there is not a two-tier market. Even in the case of lit markets, liquidity is generally accessible through market memberships, whether they are RMs, MTFs or SIs. IOIs merely represent liquidity that is available to any market participant wishing to become a user of the IOI service, or indeed using a broker that is a user of the IOI services.

4. Do you see circumstances where it would be appropriate for IOIs to be provided to a selected group of market participants? Please provide evidence/examples to support your views.

IOIs are liquidity searching tool and help improve execution efficiency for the benefit of investors. Further, if a firm is advertising their own positions then there should be no issue with providing IOIs reflecting these proprietary positions to selected market groups.

In sum, there is no reasonable argument or empirical data to suggest that any market participant is at a disadvantage due to actionable IOIs. On the contrary, market participants are at an advantage for the very benefits listed above. Consequently, this also dismisses the query that IOIs may be inconsistent with the intention of MiFID requiring RMs/MTFs to have non-discretionary rules for fair and orderly trading.

Conclusion

We commend CESR for looking at issues arising from new and emerging market activities. In determining whether to adopt new rules, or indeed to extend existing rules, in connection with this micro-structural analysis of the European equity market, we respectfully urge the Commission to carefully evaluate all available empirical evidence, to consider thoroughly through fact based analysis the potential for unintended consequences, and to insure that the benefits associated with any such proposal far exceeds the costs.

Knight appreciates the value of creating a transparent arena for which market participants, alongside regulators, can discuss the impact of the recent technological developments. Overall, Knight strongly believes that European Equity markets largely operate effectively and efficiently today. The end investor generally enjoys better executions and lower costs today than at any point in the history of the capital markets.

From our perspective, however, retail flow is often not exposed to the best prices available in the market to the detriment of investors. Retail flow should have access to all available pools of liquidity including MTFs, SIs and dark pools (where appropriate) using either smart order routing technology that is available today, or a venue that guarantees consolidated market-wide prices.[12] Knight urges the Commission to encourage the interaction between European electronic market making and retail flow.

Thank you for providing us with the opportunity to comment on the issues. We would welcome the opportunity to discuss our comments with the Commission.

[12] Equiduct – where MiFID compliant trading is provided through a unique set of product modules; OrangeVBBO (Volume-weighted Best Bid and Offer), PartnerEx and HybridBook **a**nd a flexible approach to Clearing & Settlement keeps costs predictable and low.