

Committee of European Securities Regulators

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CESR/10-142

Date
2010-04-30

Call for Evidence; “Micro-structural issues of the European equity markets”

We appreciate the initiative by CESR to review the developments and trends pertaining to the micro structure of European equity markets post-MiFID. We firmly believe that MiFID have contributed to the developments, but that the revamped regulations have not been the sole – or even main – driver. We do however recognize that MiFID have facilitated developments that are also driven by major changes in *inter alia* IT-technology and business models amongst institutions in Europe as well as globally.

The issues raised in the Call for Evidence are truly important, but they should in our view not be assessed in isolation. For example, features such as Sponsored Access, Co-location and High Frequency Trading (“HFT”) are all driven by an interest to explore new trading opportunities for which low latency is a prerequisite. In the same token, assessments of tick sizes should also be viewed in concert with the assessment of new or developed execution fee structures (such as taker/maker models).

In light of the above, we limit ourselves to make a few comments on a few of the questions in areas we feel are particularly important.

High frequency trading - HFT

Our view in respect of HFT is that it is generally to the benefit of markets. Practically, firms using HFT contributes to the liquidity and to the price formation. HFT strategies consist of both passive and aggressive liquidity, submitted on multiple markets. Passive orders add liquidity to the order books, aggressive orders creates turnover. Hence, HFT firms are one of the key drivers of fragmentation and thus competition in the European markets. The arbitrage component contributes to the evening out price differences between different pools of liquidity.

We do not think that HFT generally demonstrates any market failure and that such trading would require any new regulatory initiatives. Any risk of market abuse should be possible to manage under the current European legal framework on market abuse, and any assessment of HFT should be made within that context.

Sponsored access and co-location

Common for sponsored access (SA) and co-location is that it is used to minimize latency. The (technical) execution risk is a factor regarding the willingness to submit order to a market place. The lower perceived risk, the higher willingness to provide liquidity. Therefore, we believe that the possibility to use co-location facilities is a natural technical evolution, and increase the willingness for contributing liquidity to the market. It is important that access to co-location should be in a non-discriminatory way. Also, the fee schedules should be made public.

Our view on Sponsored Access is that it should be recognized (there is a legitimate interest to use it to gain extra micro seconds compared to standard DMA-trading), but it is imperative that the sponsor maintain not only the legal responsibility for the trades but also its possibilities to practically restrict the use of such service. In plain language, we consider that a prerequisite for Sponsored Access should be that sufficient pre-trade filters are in place and that the sponsor has sole control of such filters for clients using Sponsored Access (i.e. "naked sponsored access" should not be allowed). In the absence of such a requirement, the risk is obvious that orders could be placed in the markets in a way which potentially could cause disorderly markets. In the end, that could be detrimental to the well functioning of the markets, market confidence and also the competitiveness of European equity markets.

Fee structure

We do not think that the development of taker/maker fee structure in itself is a problem. This is not new, and it is a natural part of different venues competing for order flow. However, the concept of "paying for passive orders" may raise justified questions from the clients regarding the potential use of sell-side rebates in the routing rules of the Smart Order Router. We believe that this is already taken care of today, when it comes to well-informed institutional clients

Tick size

Harmonisation

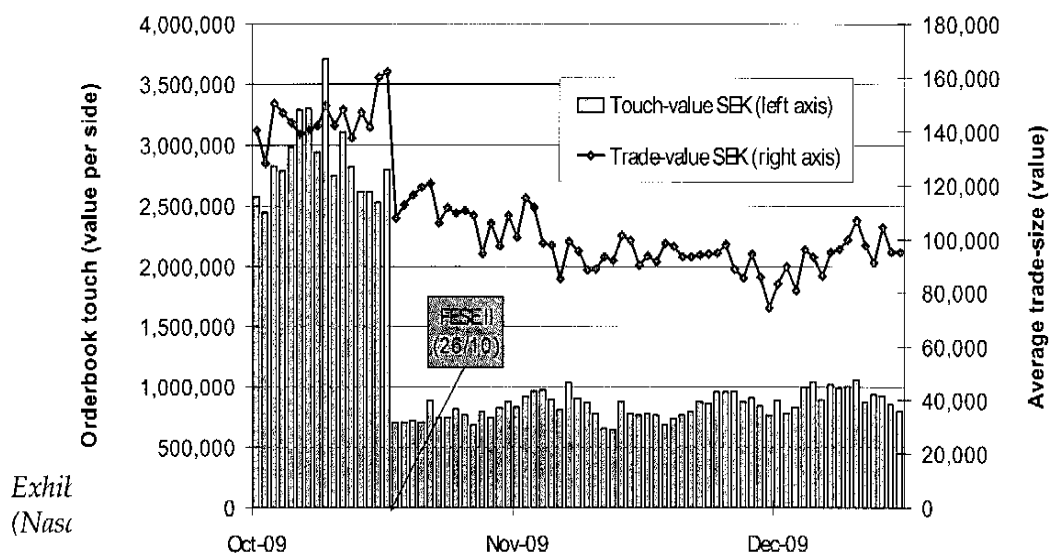
The effects of the new tick-size regime are, by now, well known. The harmonization in itself has positive effects in a radical reduction of complexity and maintenance of the trading infrastructure. Hence, we are in principle positive on the general agreement amongst major European trading venues to apply the standardized tick sizes designed by FESE. The initiative by FESE clearly shows that a market led solution has worked in this particular case. Furthermore, we do believe the need for standardization between

execution venues, is mainly for most traded stocks. There should be room for different tick sizes between venues in other segments than most traded

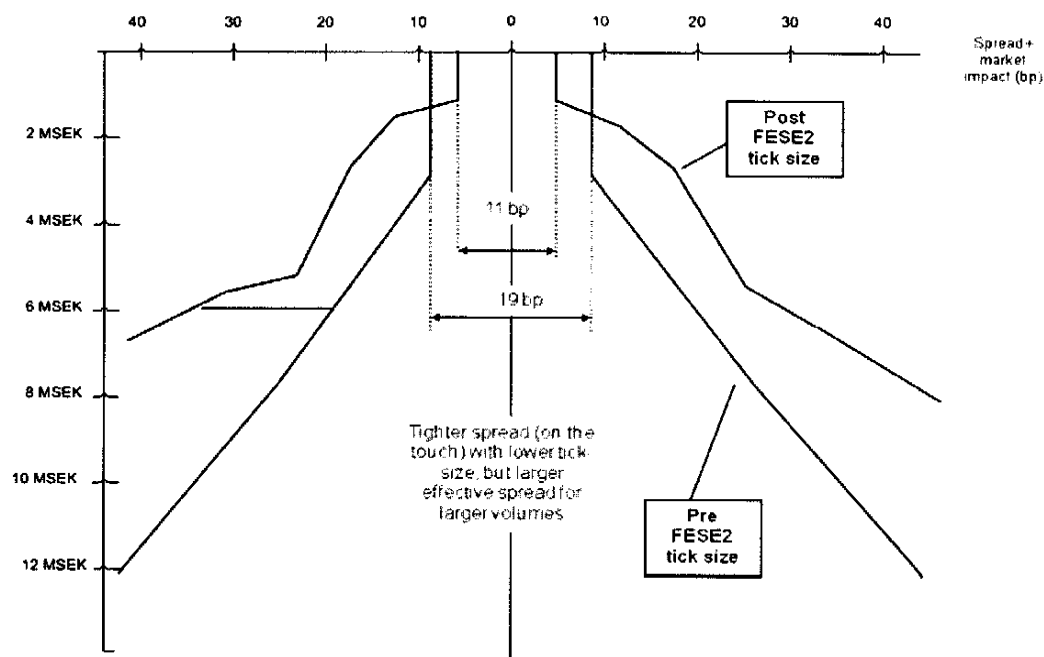
Effects on the liquidity

However, for some markets, such as the Swedish market, the harmonization resulted in a de facto reduction in tick-size on the Swedish market.

The displayed liquidity on the primary market was drastically reduced (see exhibit 1 below).



Naturally, the spread cost was significantly reduced (see exhibit 2 below), the average spread cost was reduced from 19 basis points (bp) to 11 bp. This has positive effects, captured by the retail clients. However, trading larger orders, the market impact was significantly increased (see exhibit 2 below).



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Exhibit 2 – Spread and market impact for an OMX s 30 basket, pre- and post implementation of FESE2 tick size tables

An obvious effect of this is a radical increase in demand for automation. The need for advanced Smart Order Routers and Algorithmic trading tools has increased, Furthermore, lower liquidity in the order book means that latency is even more important, not only for HFT firms. If liquidity is displayed in the order book, one need to be fast(est) to capture that liquidity. This means that the need for co-location, high capacity network etc, is not only high for HFT firms, but for a large proportion of the sell-side. This will obviously drive the cost of infrastructure even higher. Costs that are not mitigated by lower costs of execution.

Kindest regards

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