

Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V.  
Schillerstr. 20, D-60313 Frankfurt/Main

## Committee of European Securities Regulators

11-13 avenue de Friedland  
75008 Paris

your reference

CESR/10-142

your message of

01.04.2010

city\_date

**Frankfurt/Main, 30.04.2010**

CESR Call for Evidence:

## Micro-structural issues of the European equity markets

**Dear Sir or Madam,**

The *Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. (bwf)*<sup>1</sup> is a trade association promoting the common professional interests of securities trading firms and market specialists at the stock markets throughout Germany on a national, European and global level. In this capacity the bwf expressly welcomes the opportunity to participate in CESR's Call for Evidence on Micro-structural issues of the European equity markets, dated 1 April 2010 (Ref.: CESR/10-142).

In order to facilitate an efficient evaluation and further processing, our statement strictly follows the list of questions set out in the consultative document. However, since the questions themselves partly overlap in substance (e.g. "benefits" and "downsides"/"risks" are basically judgemental aspects of "impact") and the issues raised are highly interconnected, single answers should not be appraised in isolation from the overall context.

### I. High frequency trading (HFT)

#### Questions:

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

While the fundamental trading patterns of HFT strategies are very often based on rather "generic" strategies from market making through the whole universe of

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<sup>1</sup> The Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. is registered in the list of interest representatives with the European Commission under Registration No. 1880407752-10

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arbitrage concepts, it is the technical realization based on low latency automated trading supported by the latest computer technology often in combination with “co-location” arrangements, whereby the execution servers are located within the data center of the distinct trading venue, which reveals the differences.

To put it in a nutshell: HFT strategies in general try to generate head-start profits based on competitive advantages over other market participants in terms of information gathering and processing, automated “decision” making and speedier transmission of messages between an HFT entity and the trading venues to which it is connected. In the language of economic theory the speeding up of communication can be regarded as the attempt to generate and/or utilize (temporary) asymmetries of information among market participants of the same or between different trading venues which can (as long as these asymmetries exist) be exploited on a (theoretically) risk-free or low-risk basis.

In practice however, since HFT entities strongly compete with each other by permanent redesign of trading algorithms and often exorbitant continuous hardware investments, the possession of any informational edge remains uncertain in terms of substance and duration. Furthermore, it is a simple truism that the more complex and interconnected any technical system becomes, the more error-prone it can be assumed to be. Therefore, from a micro-economic as well as from a market perspective the possible inherent risks of the relatively new development of HFT strategies should not underestimated and require further empirical analysis.

**2. Please provide evidence on the amount of European trading executed by HF traders (including the source(s) of that information). CESR is particularly interested in statistical material on: a) market share of HFT in orders/trades in Q1/2010 (and, if possible compared to 2008 and 2009), b) average trade size in Q1/2010 (and, if possible compared to 2008 and 2009), c) market participants, d) financial instruments traded (including cash vs. derivatives). If possible, please distinguish between HFT on transparent organised trading platforms and on dark pools of liquidity.**

Since bwf does not conduct its own trading statistics and in absence of a generally accepted clear classification of high frequency trading, we cannot provide any hard figures on the current HFT market share in Europe. An educated guess among bwf members would suggest that at least one third of non OTC European equity trading can be regarded as HFT driven.

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

While the advent and the extraordinary growth of HFT certainly is a global phenomenon, strongly driven by technological innovation and increasingly powerful computer technology, it should not be overlooked that the stronger fragmentation of European securities market as a result of MiFID has also clearly encouraged the emergence and growth of automated trading in general and HFT in particular.

Since most HFT strategies are focused on early detection of short-term price differences and market inefficiencies, the increased number of trading venues competing for order flow, may not only have contributed to the intentional “level playing field” for all investors but also created a new, more exclusive “playing ground” for those who were willing and able to invest in fully automated HFT set ups. Such HFT entities are trying to profit from the higher complexity – not necessarily efficiency – of the more populated post MiFID trading landscape.

Besides highly sophisticated information technology, HFT strategies which are often characterized by high trading volumes but low average transaction sizes and consequently a high number of single (automated) trades in a short period of time, are strongly dependent on very low transaction fees since the generated profit margins per trade are often comparably low. Here the MTFs as the “new kids on the block” with their very often aggressive (but not always profitable) fee structures came into play: competition among traditional exchanges and new MTFs significantly reduced direct trading fees. Market participants with a high number of transactions like high frequency traders could benefit disproportionately from this development due to rebate structures introduced by most trading venues.

**4. In your view, what is the impact of high frequency trading on the market, particularly in relation to:**

- **market structure (eg. 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.**

HFT as a newly developed and strong growing form of proprietary trading unquestionably contributed to the liquidity of European equity markets in times of generally declining overall trading activities as a result of the financial crisis and damaged investor’s trust. While increasing liquidity per se can be regarded as a positive factor, the overall impact of HFT on the efficiency, stability and orderly function of securities markets is much more difficult to evaluate.

On the other hand, HFT strategies – in this respect not too different from the business models of most MTFs – seem to be based more or less on a “cherry picking” approach by focusing on the more liquid segments on the market. In other words, HFT not only accelerates the pricing frequency of securities with potentially positive effects on asset fungibility and market efficiency but is dependent

itself on market conditions with a comparably high initial order volume which allows them to build up and unwind positions within milliseconds. As a result, market liquidity will become even more concentrated with potentially disadvantageous effects for small and mid-cap market segments.

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

Although there are actually no reliable figures regarding the net effect of additional liquidity provided by HTF entities, the further increase in asset fungibility attained can be regarded as a positive effect for the effected market segments. We are more reserved with respect to other potentially positive effects mentioned in the discussions about HFT. In particular we see no evidence that the acceleration of pricing frequency per se has a positive economic effect from a market structural perspective. Like with any other good, the marginal utility of faster continuous asset pricing is diminishing, even more so when automated “decisions”, triggering price adjustments, are carried out at frequencies which make it practically impossible for any economic agent in form of a natural person to react to or at least to evaluate a situation before even newer price information arrives.

This does not mean that we would preclude any possibility that HTF – aside from increased liquidity – might also have other positive effects on market efficiency under certain conditions. However this seems to be far from self-evident and therefore calls for further substantial empirical research.

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

One critical aspect resulting from HFT activities already mentioned above lies in the potential further concentration of liquidity on certain market segments. Since turnover volume is a dominant factor for the inclusion of a specific security in a stock market index, even “technically” determined liquidity concentrations can have, at least in the long run, far-reaching consequences in terms of investor acceptance. Consequently refinancing costs for companies could be negatively affected by further thinning of liquidity in their market segment.

Another liquidity related issue arises from the questions whether HFT, while supplying additional liquidity on the one hand, does not motivate other market participants to leave the “transparent” parts of the market by increasingly sending orders to dark-pools and crossing networks because they do not want their order flow to be “targeted” by the high speed algorithms of automated traders who try to make their profit at the expense of the execution quality of more long term oriented investors. However, additional research is needed and highly desirable to examine the net-liquidity effects of HFT and the interconnection of liquidity streams among different types of markets and trading models.

Since HFT generally is based on the principle of utilizing technological superiority, special attention should also be given to the effects HFT can have on less technologically sophisticated, especially retail investors when their orders are placed within the same electronic order book. While retail investors, like any other investor, might profit in principle from increased liquidity provided by HFT, there are concerns that such advantages may be offset by negative consequences deriving from the information advantages and speedier reaction times of HFT entities.

For example, it is easily understandable that HFT significantly increases a problem known as “free trading option”<sup>2</sup>, a phenomenon which can be observed in open order book market structures in general and therefore, to some extent, can be viewed as a price investors have to pay for pre trade transparency. Furthermore, it is only fair to recall that with regard to the information efficiency assumption in its true academic sense, real market conditions have always shown some form of information asymmetries. In other words, the floor trading participants as well as professional traders in front of a trading screen with access to one or more real-time news terminals has always had an informational edge compared to the typical retail investor.<sup>3</sup> However, the decisive question in this context is whether HFT has changed the “rules of the game” to a degree that the intended “level playing field” among investors is in danger of being damaged to an extent which justifies or even calls for political intervention.

While it would be premature at this stage of the discussion to give a final answer to the question whether computer driven high frequency algorithms are harming the small and/or less technological sophisticated investor, the issue definitely deserves and requires special attention in the course of the future debate.

It is also worth while mentioning that the technological “armament race” of HFT with its significant cost implications for market infrastructure as well as the network and IT costs for market participants does not affect HFT entities alone but – at least to a significant degree – the investor’s community as a whole. While technological progress was always a driver for market evolution, a question of fair burden sharing and potential externalisation of costs arises when the level of technology desired and/or employed differs significantly among market participants.

Furthermore, the technological as well as the administrative resources of existing market surveillance infrastructure need to be “upgraded” and expanded in order to effectively monitor – and if necessary intervene in – market movements. This of

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<sup>2</sup> In an open order book environment, limit orders can be viewed as providing the market with a free put (call) option to sell (buy) shares whenever new information arrives at the market which justifies a price lower (higher) than the stated limit. Market participants can only be prevented from exploiting this “free trading option” if investors timely adjust their limits. For the “average” even “professional” investor this becomes an increasingly difficult, if not impossible, task in a HFT environment.

<sup>3</sup> On the other hand it is worth mentioning that the advent of the internet did neutralize large parts of these asymmetries.

course is not only a cost issue but a question of market integrity and stability. It was widely accepted long before the advent of HFT that fully electronic markets – even more if a growing part of orders executed are purely computer driven – need close monitoring and effective “circuit breakers” (e.g. “volatility-interruptions”) must be in place to provide for an orderly function of the market in periods of stress and in order to minimise the risks arising from erroneous trades or program failures. Even though there is no reported case yet where HFT has led to a sincere market failure, it is not a new insight that trading “decisions” made by computers bear their very own threats for the orderly functioning of security markets – with the “program trading crash” of 1987 being already an historical text book example.

Regulators and policy makers alike therefore should have a close look not only at HFT entities themselves but at market surveillance infrastructure as well. Without any doubt, it is a simple necessity for the utility of the market as a whole as well as for any single trader that market surveillance, in terms of resources and technology, can operate on eye level even with the most sophisticated and technological equipped market participants. Furthermore, the current discussion about co-location and pre-filtering unveils that in a world of steadily increasing competition for order-flow and high margin pressure possible conflicts of interest for market operators should not be neglected.

Last but not least, the question of how the process of ex ante evaluation of trading venues in the context of best execution obligations under MiFID can be affected by market conditions changing in milliseconds should be given appropriate attention in the future debate.

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

While we are rather sceptical about the benefits of HFT for the majority of retail and professional investors alike, more empirical research based on accurate and reliable data is needed to make qualified judgements about the overall impact of automated, low latency trading activities. However HFT, as shown above, raises a number of regulatory issues which should be closely examined not only from a purely academic but from a regulatory and policy-makers perspective as well.

**8. How do you see HFT developing in Europe?**

Since HFT models are dependent on multiple factors whose future development is subject to a high degree of uncertainty themselves (fragmentation of the trading landscape, price competition among market operators, overall market activity, the speed of technological innovation and last but not least the future path of capital market regulation) it is hard to predict how HFT will develop.

However, what can be said is that any additional reduction of latency, on which the competitive edge of basically all HFT strategies is based, will be increasingly

costly, therefore the gap between marginal costs and marginal profits shall be narrowing as long as increasing technology costs are not offset by other factors such as additional rebates in trading fees offered by market operators.

**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?**

Aside from the demand for appropriate surveillance infrastructure which at any time needs to keep pace with technological developments on the trading side, any additional regulation should be considered very carefully, based on sound empirical analysis and targeted always on a specific clearly identified and well defined problem. In this context it has to be kept in mind that raising the general level of regulation inevitably would add to the overall costs of trading. Considering that such an effect may be in particular hard to cope with for those market participants who find it already increasingly difficult to be forced to continuously invest in cutting edge technology which adds little additional value to their own, more traditional and long term oriented trading strategies and business models, additional regulation will always remain a double edge sword.

It should also not be forgotten that it was regulation itself – by fostering fragmentation of liquidity as a result of the MiFID framework – which substantially contributed to market structures that HFT-entities obviously find attractive.

## **II. Sponsored access**

### **Questions:**

#### **1. What are the benefits of SA arrangements for trading platforms, sponsoring firms, their clients and the wider market?**

The intention of trading platforms to offer “sponsored” access connectivity is very simply to increase liquidity and the number of orders routed to their system in order to make their venue more attractive for existing and new participants and to better utilize the technological infrastructure necessary to operate this particular market place.

The most obvious benefits for a market member becoming a “sponsor” for a non market member are an extension of its service portfolio and thereby its sources of revenue as well as a reduction of its own transaction fees by increasing the overall trading volume attributed to him which might enable him to profit to a higher extend from volume based rebates offered by the trading venue.

The core benefits of the “sponsored” client can be characterized as the obtainment of direct market access at lower operational costs – compared to becoming

a member itself – and the significant reduction in latency compared to using an access model whereby its orders are routed through the system of the market member providing access.

Depending on the contractual arrangements between “sponsor” and “sponsored” client, the client may also participate in the described possible rebate of transaction fees obtained by the “sponsor” as a result of aggregating its “sponsored” client’s order flow.

## **2. What risks does SA pose for the orderly functioning of organised trading platforms? How could these risks be mitigated?**

When discussing potential risks of sponsored access it is important to unambiguously define its scope and meaning. We therefore appreciate that CESR has made clear that the term “sponsored access” should only be applied where two essential conditions are equally fulfilled:

- The “sponsored” client is not a member of the execution venue it seeks access to and
- the “sponsored” client sends its orders directly to the execution venue without passing through the “sponsor’s” internal system.

As a result, any pre-execution control of the “sponsor” over the order flow of its “sponsored” clients does solely depend upon technical infrastructure provided by and made accessible to the “sponsor” by the trading venue itself.

Since the “sponsored” client’s transactions are executed in the name of the “sponsoring” member who in its contractual relationship with the trading platform is financially responsible for the trades of its clients to be fulfilled, the trading platform will treat the “sponsor” and its clients as a single risk entity. Therefore, from a risk management point of view, there is little difference between a proprietary or non-“sponsored”-access client order and its “sponsored” access equivalent. However, the trading platform will have to take into account that the “sponsored” client, which is by definition not a member of the trading platform, has not undergone the due diligence process required to qualify for membership and the span of control of the “sponsor” regarding its “sponsored” clients’ activities is limited.

## **3. What risks does SA pose for sponsoring firms? How should these risks be mitigated?**

Given that the trading platform – as it seems to be European standard – provides the “sponsor” with pre-trade monitoring, validation and control instruments comparable to those procedures applied to the “sponsors” proprietary or non-“sponsored”-access client orders and the “sponsor” effectively utilizes those systems, the additional risk can be reduced to an operational risk component resulting from the increased reliance on the trading platform’s infrastructure for the



purpose of controlling risks arising from “sponsored” clients’ transactions. It is also worth while mentioning, that timely post trade monitoring on the based on ex-post trade information made available for the sponsoring firm by the market operator (so called “drop copies”) can be a valuable source of risk management information. However, which “concert” of pre- and/or post-trade validations and controls can be deemed appropriate from a “sponsoring” firm’s – as well as from a regulatory – point of view is hard to generalize.

Conversely, there is no doubt that the complete absence off any form of adequate controls on the side of a “sponsoring” firm regarding the trading activities of its “sponsored” clients – as referred to as “naked” access in the US-lead debate – could, under a worst case scenario, dramatically increase the risk of the “sponsoring” firm and may even have implications for the orderly function of markets and thereby may also raise systemic risk concerns.

#### **4. Is there a need for additional regulatory requirements for sponsored access, for example:**

**a. limitations on who can be a sponsoring firm;**

**b. restrictions on clients that can use sponsored access;**

**c. additional market monitoring requirements;**

**d. pre-trade filters and controls on submitted orders.**

The existing legal framework in Europe already obliges firms to have risk management systems employed which are adequate and proportionate to a firm’s proprietary and client-related execution business. We therefore believe that it is first and foremost a regulatory monitoring – and where needed enforcement – exercise in order to insure that “sponsored” access does not create any regulatory “blind spots”.

However, since it cannot be denied that hard competition among sponsoring firm and the strong economic incentives for ever lower latency (which may be further reduced by “naked” or insufficiently monitored “sponsored” access) can put significant pressure on “sponsoring” firms to offer “sponsored” access arrangements which are weighting aspects of “speed” higher than those of “safety”, regulatory oversight therefore should indeed give “sponsored” access arrangements special attention.

#### **5. Are there other market wide implications resulting from the development of SA?**

At the moment, we have no further comments regarding broader implications arising from “sponsored” access practices.

### III. Co-location

#### Questions:

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

Rather than being a generic phenomenon, co-location should be regarded as a technical aspect and a logical consequence of HFT, even more so in a trading landscape which is increasingly characterized by fragmentations of liquidity and the necessary coverage of a multitude of execution venues at a geographical distance but trading the same – or an increasingly overlapping – set of securities. For those who are active in HFT, physical proximity to the exchange-server has already become a pure necessity to “stay in the game”.

Since the business model of most MTFs is based on mirroring the liquidity of the reference markets with whom they compete via transaction fees, co-location arrangements in conjunction with high speed networks are beneficial for low latency traders and market operators alike. However, while co-location arrangements have particular importance for MTFs, they also provide established exchanges with a welcomed opportunity to widen their technological product range.

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

While market operators, including the traditional exchanges, try hard to argue that co-location does not violate the principle of non-discretionary access for market participants, it is hard to deny that those market participants who are not able or do not want to invest in co-location arrangements increasingly find themselves at a technological disadvantage. However, the economic impact of such a competitive weakness may still vary according to the individual business model.

Furthermore the growing numbers of co-location arrangements, like any other new technological requirement demanding additional material investments, are likely to convey further concentration processes over time simply because larger entities find it easier to break down increasing fix-costs.

Since co-location is a key driver in further reducing latency, the critical remarks already made under point I.6 should also be taken into account when discussing possible negative effects of co-location arrangements.

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

As mentioned before, co-location can not be seen in isolation. Consequently, its impact is widely the same as the impact of HFT discussed in section I.

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

Please see answer given under point, I.6. – In particular, it can be expected that the “free option problem” will be further aggravated by co-location arrangements.

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

Please see answers given under points I.6 and III.2.

**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.**

Co-location arrangements, without any doubt, are increasing the complexity of a firm’s technological infrastructure. From a regulatory point of view special attention should be paid to ensure that the fulfillment of existing organizational and administrative regulatory provisions does not suffer as a result of “transplanting” parts of the infrastructure to execution venues’ data centers.

This said, we would not be supportive of any new specific regulatory provisions to be fulfilled for the running of co-located IT-infrastructure. Since any new set of regulatory requirements would also translate into higher cost to set up such structures, it would inevitably further increase the “barriers of entry” for smaller and mid-size firms to participate in this new technology.

Aside from this, co-location is one factor – albeit a very important one – among others in the attempt to generate faster market access. Whether the privileges in terms of reduced latency and informational edge arising from it should be tolerated as “normal” differentiation among market participants or not, is a merely political issue.

#### **IV. Fee structure**

##### **Questions:**

**1. Please describe the key developments in fee structures used by trading platforms in Europe.**

Most European securities markets in the pre MiFID era were characterised by a de facto monopoly of national exchanges whose only competitor was the less transparent OTC-segment, only accessible for certain professional investors. Even though the situation in Germany with its variety of regional exchanges was still is

slightly different, the dominant position of Deutsche Boerse Group was already apparent.

The new legal framework under MiFID enabled new trading platforms, characterised as “MTFs” to compete with established exchanges. However, since liquidity is “sticky” MTFs had to offer aggressively low – and seldom cost-effective – execution prices and rebate schemes in order to attract order flow. Most prominent, and to some extent extreme in its concept, is the so called “maker-taker-pricing” which rewards the provision of liquidity<sup>4</sup> by an even “negative transaction fee” or “liquidity refund”. Hereby, the order router is given an “artificial” incentive to extract and thereby “mirror” liquidity from a liquid reference market to the new venue.

Since a market place utilizing a “maker-taker” scheme can only generate positive revenues by charging the “taker” which extracts liquidity by matching an order already on the book, it is easily understandable that MTFs with “maker-taker-pricing” usually have a strong focus on high liquid market segments – in other words, are following a “cherry picking” approach. Understandably “maker-taker-pricing” was – and still is – eminently attractive for and therefore invites automated high frequency trading which arbitrages the artificial spread created by the remuneration of liquidity provision.

However it is still highly uncertain how many business models of the newly emerged MTFs will be sustainable in the long run. Another issue worth while addressing is the question whether there is a structural disadvantage in price competition for regulated markets, namely the traditional exchanges, since the higher level of regulation also implies a higher administrative burden.

## **2. What are the benefits of any fee structures that you are aware of?**

From an investor’s point of view the new price competition has clearly had positive effects by triggering a strong downward pressure on direct transaction costs and fostering increasing pan-European trading.

## **3. Are there any downsides to current fee structures and the maker/taker fee structure in particular? If yes, please describe them.**

From a textbook perspective, the most easily identified “downside” is the increased fragmentation of liquidity which might have a derogatory effect on the quality and effectiveness of price formation. Furthermore, since the market impact of executing an order increases in a fragmented environment, the incentives to execute large orders OTC or in a dark-pool is likely to have increased despite falling direct execution fees.

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<sup>4</sup> Characterized by the routing of a „passive“ order waiting to be matched on a particular execution venue.

In a world where trading venues competing for order-flow by aggressive fee structures are organised as for profit organisations, dependent on a high degree of capacity utilization of their expensive technological infrastructure, transaction pricing inevitably becomes a marginal costs exercise. As a result, not all investors may profit to the same extent from the reduced pricing levels. From a market operator's perspective, it is only rational to offer the lowest fees to high volume clients, e.g. high frequency traders, whose high turnover/low margin business models are conversely extremely sensitive to transaction costs.

**4. What are the impacts of current fee structures on trading platforms, participants, their trading strategies and the wider market and its efficiency?**

Please see answers given under points IV.2 & IV.3.

**5. How important is the fee structure of a trading platform in determining whether to connect or not to it for trading. Please elaborate.**

While investors – other things being equal – obviously would always prefer lower than higher execution fees, price elasticity with regard to transaction fees (and therefore the willingness to connect to a specific venue or not) may vary significantly depending on the specific characteristics, the complexity and magnitude of the individual trading business. For any high volume/low margin business like HFT, price sensitivity can be assumed to be considerably above average.

**6. Do you consider that the fee structures of trading platforms should be made public to all market participants? Please provide a rationale for your answer.**

Transparent fee structures are clearly a necessary prerequisite for non-discretionary access to trading venues. Furthermore, information about fee structures is one of the constitutive factors for order routing decisions under the MiFID best execution-regime – bwf therefore strongly supports the requirement for market operators to publish detailed and non-negotiable fee structures.

**7. Is there a role for regulators to play in the fee structures? If yes, please describe it.**

Regulators should make their contribution to ensure fair price competition among trading venues and different groups of investors alike. As a minimum requirement they therefore should insist that trading venues operate on the basis of a fully transparent, non-discriminatory fee structure.

We also think that the point of potential competitive disadvantages for regulated markets compared to MTFs, as raised in point IV.1., deserves further regulatory attention and analysis.

## V. Tick size

### Questions:

**1. In your view, what has been the impact of smaller tick sizes for equities in Europe on the bid-ask spreads, liquidity, market depth and volatility of these markets? Are there any spill-over effects on derivatives markets?**

In principle smaller tick sizes enable investors to set more precise order limits thereby contributing to efficient price formation. However, from the perspective of an investor who does not operate in very short time frames the marginal utility of ever smaller tick sizes is clearly diminishing and may be even negligible beyond a certain point. In less liquid markets, tick sizes which are too narrow could even be disadvantageous for the price formation process, since the increased number of possible trading limits resulting from smaller tick sizes may aggravate order-matching.

Furthermore, there can be little doubt that the systematic reduction of tick sizes observed in the recent past were first and foremost intended to extract liquidity from other trading venues by creating further possibilities for inter venue arbitrage rather than promoting a more accurate asset-pricing.

**2. What are the benefits/downsides of smaller tick size regimes for shares in Europe?**

Please see answer given under point V.1.

**3. Is there a need for greater harmonisation of tick size regimes across Europe? Please elaborate.**

On this point, we are in agreement with the FESE proposal that tick sizes should be harmonised, respectively that a minimum tick size should be defined.

**4. Is there a role for regulators to play in the standardisation of tick size regimes or should this be left to market forces?**

It would be highly welcomed if an agreement about adequate tick sizes could be obtained as a result of an industry initiative. If such an attempt should fail, we would support the idea of regulators playing the role of a standard setter based on prior industry consultation.

**5. Have organised markets developed an appropriate approach to tick sizes?**

Please see answer given under point V.1.

**6. Should regulators monitor compliance with the self-regulatory initiative of the MTFs and FESE? If this initiative fails, do you see a need for regulators to intervene?**

Please see answers given under points V.3 & V.4.

**7. What principles should determine optimal tick sizes?**

Tick sizes should be defined on the basis of the price level and market liquidity of a specific security.

**VI. Indications of Interest (IOIs)**

**Questions:**

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

An Indication of Interest (IOI) can be described as the non binding communication of a firm's proprietary or client's buy- or sell-side trading interest in a specific security. The content of IOIs may vary containing one or more of the following elements: name or identifier of the security in question, side of the market, acceptable price and/or size of the potential transaction. IOIs can be either communicated on a bilateral basis and/or advertised through proprietary systems and/or third party communication networks e.g. Bloomberg or Thomson Reuters terminals. IOIs are also often communicated via e-mail based on individually compiled mailing lists of a firm's clients and regular trading counterparties.

While IOIs can show different degrees of informational depth they are regularly missing detailed instructions on execution arrangements and post trade processing which have to be negotiated on a bilateral basis before a transaction accrues from an IOI. It is worth while mentioning that IOIs are a generally accepted market practice and a valuable form of communication, contributing significantly to increased pre trade transparency in the institutional OTC market segment in Europe as well as on a global scale.

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

IOIs help market participants to identify counterparties respectively to detect market liquidity in particular in the course of executing large orders or block trades where indirect transaction costs born by market impact are a major concern.

The possibility of the "smooth" acquisition or unwinding of large positions facilitated by IOIs increases the potential interest of institutions to invest in securities

of lower liquidity and thereby structurally supports issuers to fulfil their financing requirements at lower costs while reducing the transaction costs of investors accordingly.

In principle it could be argued to the contrary that IOIs create an environment of privileged or asynchronous information since their communication is almost completely limited to the institutional segment of the market. However, such an argument seems to be highly “academical” in nature and without practical relevance since IOI based transactions on a regular basis are well above average market size and thereby lie outside the scope of non-professional or retail investors.

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

As mentioned above, the publication of IOIs via widely accessible communication networks is already common market practice where such an “advertisement” is deemed helpful by investors expressing their trading interests. On the other hand, in cases where an investor does not wish to “unveil” his or her trading interest to a broader audience, the impact of any mandatory publication of IOIs under a pre-trade regime would be clearly prohibitive. In other words market transparency, most likely, would not be increased but reduced.

Furthermore, even though a considerable amount of IOI based transactions may be executed according to the trading interest initially indicated, it would be wrong to assume that such IOIs are “actionable” in the sense of any other limit order since they require almost always further negotiation on execution and post execution arrangements.

For the reasons given above and since we can not identify any kind of market failure arising from current IOI practices we are not supportive of the idea to make IOIs subject to any form of mandatory pre-trade transparency under MiFID.

**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.**

Please see answers given under points VI.2 & VI.3.

Yours faithfully,

Michael H. Sterzenbach  
Secretary General