

FESE Position on Dark Pools and Broker Crossing Networks

FESE wrote to CESR last year to urge for greater transparency on equity OTC trading in general and on crossing networks in specific. We welcome the fact that CESR has started a work stream on this subject and look forward to viewing the initial findings.

Much has been written in the press over the last year regarding 'dark pools'. As the issue is technical and definitions are not widely established, some of FESE's views have been reported inaccurately or incompletely. Our aim is to contribute to this important debate by providing clarity on the available facts and the long-standing positions we have taken:

1. On the data:

- Brokers and exchanges fully agree that over-the counter-trading (OTC) is as much as 30-40% of equity trading today in Europeⁱ. Best available public sourcesⁱⁱ show that, over 2009, an average of up to 38% of all equity trading took place on an OTC basis, i.e. outside all three of the MiFID trading venues (Regulated Markets, Multilateral Trading Facilities and Systematic Internalisers). In December 2009, OTC volumes were estimated at 386 billion Euros. For comparison, the other venue types had the following market shares in 2009: RMs 50%; MTFs 10%; and SIs 2%. (Please see [chart](#)).
- While the granularity and comparability of OTC reporting need to improve, the approximate magnitude of OTC trading is not contestedⁱⁱⁱ. This suggests that MiFID has failed to attract the bulk of equity trading to RMs, MTFs or SIs, as was its original intention.
- Of the overall OTC trading, a certain type of business – operation of automated multilateral liquidity pools akin to MTFs - poses a particular concern for price formation and fair competition. There is no public information on how much of the OTC trading has such characteristics. FESE urges for greater transparency in this regard, while also asking for any such business, irrespective of individual or aggregate size, to be classified properly^{iv}.

2. On the concepts:

- It makes a big difference whether a certain trading functionality is defined properly. OTC trading is subject to general broker-dealer rules of MiFID, but is not subject to the specific protection and guarantees of trading venue rules, and notably fails to contribute to the public price formation process. OTC rules are fine for truly OTC trading, but are inadequate for multilateral trading done by brokers. Thus the concern is not that broker platforms are 'unregulated' but that they are not regulated as venues. Applying appropriate rules to them would help protect public price formation, safeguard equal treatment of investors, ensure orderly order execution, and allow for a better monitoring of market integrity.
- A related point is that 'dark pools' and 'crossing networks' should not be confused. Dark pools are a specific type of MTF, are fully MiFID-compliant, and allow market participants to limit the market impact of large orders subject to clear guidelines^v. By contrast, crossing networks seem to execute large and small orders away from RMs and MTFs without pre-trade transparency or any of the other controls applicable in these venues.
- FESE deems it essential to analyse the breakdown and business models of OTC trading in order to determine whether any MiFID provision is being mis-applied or whether the problem lies within the design of MiFID provisions. In either case, corrective measures must be taken to ensure that all kinds of trading with the same functionality are regulated and supervised in the same way.

END NOTES:

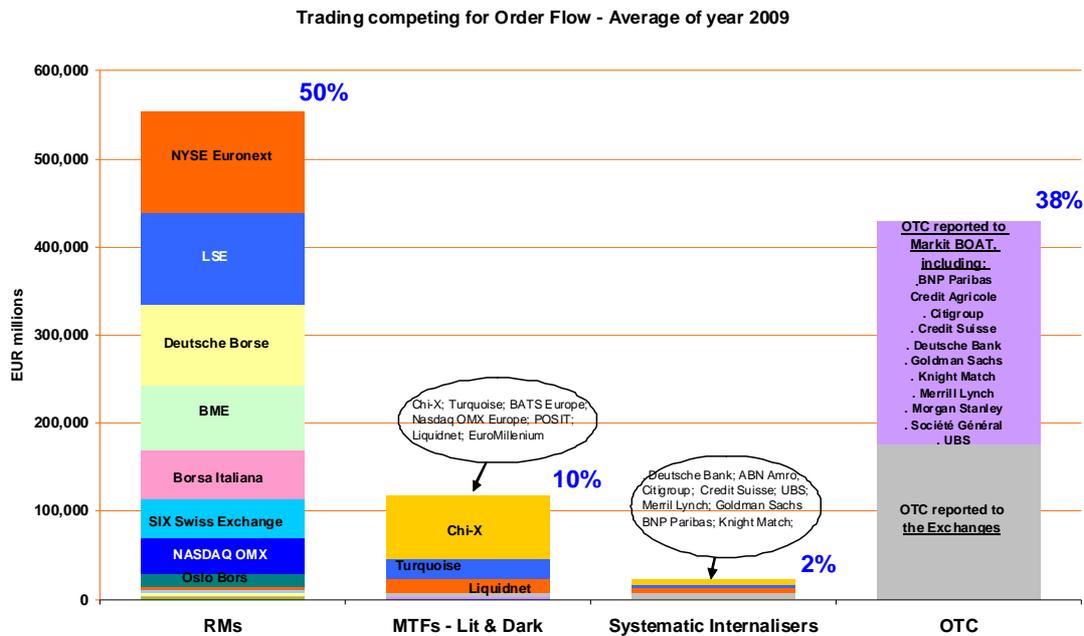
ⁱ October 2009, TABB Group paper ‘Trading in the Dark in Europe: Choice and Complexity on the Cusp of Change’ estimates that the share of OTC including crossing networks in the European market is about 33%. The report is not fully comparable with EU sources due to differences in terminology and methodology; however, its global OTC estimate is broadly in line with the statistics of Markit Boat, which reports a volume for OTC in 2009 which corresponds to 38% of the overall market.

ⁱⁱ RM and MTF volumes come from the FESE European Equity Market Report (EEMR); OTC figures come from Markit Boat. During 2009, the market share of OTC reported by Markit Boat and Exchanges fluctuated within a range of 32% (July 2009) and 46% (May 2009). Its absolute level fluctuated between 309 billion Euros (August 2009) and 612 billion Euros (May 2009).

ⁱⁱⁱ In fact, in certain equity segments, OTC accounts for an even larger share, above 50%. According to the European Securities Markets Expert Group (ESME), in May 2009, the share of OTC in the DAX 30 shares was 55%, in FTSE 100 it was 33%, and in CAC 40 it was 41% (‘Fact finding regarding the developments of certain aspects of pre-trade transparency in equities under MiFID’ - 27 July 2009). In fact, in certain equity segments, OTC accounts for an even larger share, above 50%

^{iv} Given that MiFID sets no threshold for multilateral business to qualify as MTF and considering the relative market shares of the three main venue types, even a seemingly small amount of multilateral trading currently taking place in the OTC space could generate problems for the market and supervisors.

^v Many FESE members as well as other operators have set up execution venues to allow dark pool trading within the framework of MiFID.



Note: Analysis based on different sources: FESE EEMR, Markit Boat and Thomson Reuters. Reviewed with the latest figures available.