DUTCH PROPRIETARY TRADING INDUSTRY VIEWS ON SPEED BUMPS THAT AIM TO IMPROVE LIQUIDITY PROVISION

Objective and background of this paper

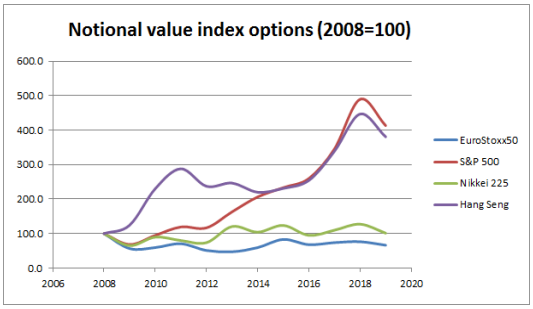
For the benefit of exchanges, government and regulators, APT would like to provide insight into thinking within the Dutch proprietary trading industry on passive liquidity protection (PLP), latency advantage mechanisms and asymmetric intentional access delays measures ("speed bumps"). APT notes that this is a topic that is attracting increased attention both within Europe and beyond. The direct reason for this paper is the recent Eurex PLP initiative and ESMA looking into the implications of intentional access delays on the structure of EU markets.

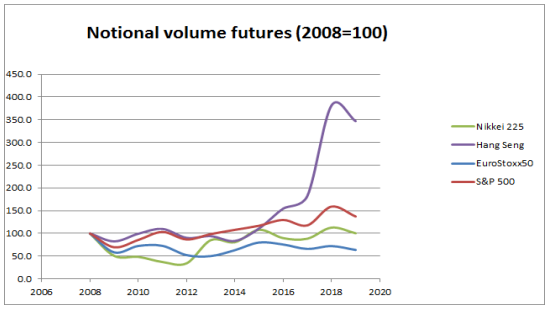
Association of Proprietary Traders

APT represents 23 independent proprietary trading firms based in the Netherlands. Since the opening of the first European options exchange in 1978, Amsterdam has become an important global centre for proprietary trading, with a concentration of both large global proprietary trading firms as well as smaller operations. Most of APT's members operate as market makers on exchanges in and outside the EU and buy and sell financial instruments on own account, including shares, options, futures and ETFs. Market makers commit to providing liquidity to the market under all circumstances, a practice codified in MiFID II. APT supports evidence based market structure initiatives that would improve the liquidity picture and attract more volume to the screen, lead to tighter pricing and more order book depth to the benefit of the investing public.

Liquidity provision in Europe is falling behind and improvements are needed

The debate on speed bumps and other market structure changes comes at a time of declining market volumes and activity within the EU. It is the opinion of APT members that since the global financial crisis EU markets, when compared to US and Asia-Pacific markets, are falling behind in liquidity provision and notional value traded. This has been particularly pronounced on the derivatives markets, most notably in the (index) options space, as shown by the graphs below. Unless addressed, this trend could become a self-fulfilling cycle whereby the lack of liquidity leads to investors, market makers and other market participants to allocate capital to other more attractive global markets. We appreciate exchanges' efforts to innovate and improve liquidity provision in the marketplace.





Wishes of the "buy side" as a starting point for any solution

Given the above trend, when considering initiatives to increase liquidity provision on EU markets a starting point must be to find out more about how end investors such as asset managers, pension funds and retail investors can be attracted to allocating more capital to EU companies and EU markets.

- What is currently holding investors back from entering or increasing their allocation to the EU market?

- Is there a lack of available liquidity? Does Europe's fragmented post-trade environment and associated higher costs act as a barrier to increased investment and activity?

Consider liquidity protection measures holistically.

Possible measures that could enhance liquidity provision should not be considered in isolation. Questions that could be taken into account are:

- What positive and negative effects does the existing market structure, based on a combination of governmental and exchanges policies, have on liquidity provision? Are there plausible explanations for the dip in liquidity on European markets that would not be solved through a market microstructure change alone?
- Are changes in tick size, pro rata matching and latency mechanisms complimentary or alternatives to reaching the desired objective? Which complimentary and/or alternatives measures could be considered?
- What is working well in successful and comparable markets where liquidity provision is up to par?
- Could stimulating more competition between liquidity providers by amending market maker programmes lead to more liquidity?

Pro and contra speed bumps

Within the APT membership views differ as to whether speed bumps will indeed lead to more liquidity to the order book to the benefit of the investing public. Effects of speed bumps should therefore be studied in more detail.

Pro speed bumps

- Market making liquidity providers are more at risk than liquidity takers. Multiple liquidity takers can target liquidity via multiple paths at minimal risk if they fail. The provider, on the other hand, is alone and at risk of adverse selection if they fail to pull their quote in time. A market maker who is unable to adjust sufficiently to this risk will either widen their spread, show less liquidity or exit the market which is detrimental to market diversity. Speed bumps could lower these adverse selection costs, by decreasing the gap between faster liquidity providers and liquidity providers with a speed disadvantage. More specifically, the Eurex PLP framework artificial delay on aggressive orders in their matching engine could be a way to create a time window in which passive liquidity can be protected.
- Speed bumps improve the heterogeneity of the market, by lowering barriers to entry for market makers and widening the pool of participants successfully quoting. This could improve price discovery and liquidity provision. Initial results on Eurex show that spreads have tightened and sizes have increased in the pilot groups compared to the control groups. However, although statistically significant, the improvements are still marginal. During the remainder of the pilot, the expected effects have to be evaluated further. Results do show that illusory liquidity is not affecting the buy side directly; more than 99% of protected liquidity is market maker vs. market maker.

Contra speed bumps

- One of the most significant concerns regarding speedbumps, is that they positively facilitate 'quote fade'; fleeting, illusory or "phantom" liquidity. An asymmetric speedbump can provide for a misleading impression of available liquidity in the market, which is undesirable from a pre-trade transparency perspective.
- Market participants including makers also supply liquidity to the market when taking. Asymmetric speed bumps discriminate against liquidity takers and indirectly impact market makers ability to hedge (perhaps in an alternative product that is subject to speedbump) or unwind risk.

- Any asymmetric speed bump mechanism like Eurex' PLP increases the risk of adverse selection for liquidity providers on other exchanges without asymmetric delays, which will cause spreads to widen at those venues. The net impact is the likelihood of speed bumps proliferating across European exchanges, as each market must move to defend itself against the ripple effects
- One of Eurex' objectives is to attract more US funds that currently trade exclusively in US markets to also deploy their strategies in Europe. However US options exchanges have simple matching algorithms and easy-to-understand rules. Introducing speed bumps in Europe runs the risk of making US exchanges comparatively even more attractive for investors than they already are.

Caveats on the design of speed bumps

When designing speed bumps, a number of caveats need to be taken into account:

- Speed bumps add further complexity to the markets, which could have a negative effect on transparency.
- Speed bumps should be a means to an end to solve the problem of lack of liquidity provision and situations where tighter pricing and more order book depth is called for to the benefit of the investing public. Market structure innovations should be designed to be the "minimum effective dose." If the specific market is not in need of improvement, don't try to fix it.
- Too much protection might introduce free optionality for the liquidity provider ('gaming'). In that respect, it is important to closely scrutinize the precise effects of deferral time lengths.

Possible next steps

If speed bumps start passing the pilot phase, a decision to encompass these measures into the exchange structure on a more permanent basis should be based on sound data collection, systematic experimentation and careful reflection that has led to clear evidence that liquidity provision has improved, the heterogeneity of the market has improved, order books have become more attractive for the investing public and traded volumes have gone up. Have buy-side order sizes and size of orders filled at BBO increased? Have effective spreads decreased? Despite more volume, parties might still not be willing to take liquidity, which will eventually reduce the liquidity picture.

The way forward seems for exchanges to collect more data on the impact of market microstructure pilots, compared against a control group, to ascertain if speed bumps indeed achieve their stated objective. F.e. data should be collected about (ripple) effects on overall liquidity, "illusory" liquidity and liquidity on other exchanges.

We believe outcomes should first be studied in depth before possible governmental intervention in this field is considered, as each venue and product has a very specific set of conditions. However, if asymmetric speed bumps start to become a trend.[1] ESMA should have an important role in studying the cross-market impacts on market quality as a whole.

More information?

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[1] At least three exchanges are exploring this type of mechanism (Eurex, ICE, LME): marketvoice.fia.org/articles/eurex-test-speed-bump-equity-options