Dear Mr. Docters van Leeuwen:

The Securities Industry Association is submitting this comment letter in response to the Netherlands Authority for the Financial Markets’ (“Authority”) request for comments on its position paper on in-house matching (“Position Paper”). We believe that an open and transparent consultation process will facilitate the development of an appropriate regulatory framework for the European capital markets of the 21st century. We therefore welcome the opportunity to comment on the Position Paper.

Summary

While we agree with the Authority’s conclusion that in-house matching of agency orders and principal trades should be allowed, we are troubled by the conditions that the Authority seeks to impose on activity with retail clients. The Position Paper proposes sweeping changes to market practice in most European Union member states without any empirical evidence that market forces have failed to meet users’ needs in an optimal way. In addition, the Position Paper overstates the benefits of pre-trade transparency and, as a result, does not give sufficient consideration to other factors that contribute to the ultimate objective of efficient markets and protection of investors’ orders.

Introduction

SIA commends the Authority for recognizing the role that in-house matching plays in serving the needs of both wholesale and retail investors. Different trading mechanisms have evolved because users have different types of transaction demands and different definitions of execution quality. When there is competition between venues, investors will choose the market that provides them with the combination of factors (i.e., price, speed of execution, anonymity, transparency, liquidity and transaction costs) that best fits their preferences. In-house matching serves the needs of investors for whom fast, reliable executions and/or avoidance of market impact are the most important priorities (of course, a broker-dealer that accepts an order from its customer and matches that order in-house still owes a regulatory duty of best execution to its customer).
Investors should be free to have their orders executed in the way that they desire, including by not exposing an order to the market. In this regard, we strongly agree with the Authority’s conclusion that in-house matching is consistent with best execution goals and should be allowed.

We disagree, however, with the conditions that the Authority seeks to impose on in-house matching of retail orders. The Authority asserts that in-house matching of retail orders could have a negative impact on liquidity in the main liquidity pool, result in wider spreads and more volatile prices, and damage the quality of price discovery. Based on these assertions, the Authority takes the position that, to ensure the adequate functioning of markets, in-house matching must be subject to two conditions: (1) full pre-trade transparency and (2) access. We refer to these requirements together as “mandatory order exposure.” As explained below, such a policy orientation is misguided.

No Empirical Evidence in Support of Mandatory Order Exposure

As a general matter, competition and choice, rather than regulatory intervention, should be the principal determinants of an “efficient market.” A regulator should mandate a significant change in market practice if (and only if) it can demonstrate that market forces have failed, or are reasonably likely to fail, to meet users’ needs effectively or that such a change is necessary to protect against systemic risk. The Authority has not produced any empirical evidence that in-house matching without full pre-trade transparency and access is detrimental to investors or that mandatory order exposure would result in more efficient markets.

The Authority does not analyze available data regarding the effects of in-house matching on liquidity and price discovery in the U.S. and U.K., data which suggests that in-house matching is not necessarily detrimental. Empirical research conducted in this context shows the beneficial effects of order internalization activity on spreads.

1 As described in the summary section of the Position Paper, the Authority believes that “[a]ll players [should] have equal access to relevant information pertaining to proposed transactions and should be able to transact all orders.”

2 The U.S. Securities and Exchange Commission (“SEC”) has considered the effects of internalization on several occasions and, each time, has decided not to prohibit the practice. The issue arose most recently in
For example, one study concludes that the ability of Boston Stock Exchange and Cincinnati Stock Exchange members to internalize orders had “…little short-run effect on posted or effective bid-ask-spreads.” Indeed, the results of the study contrast with the “…adverse effects of market fragmentation and internalization predicted.” In sum, although the U.S. and U.K. markets do not provide full pre-trade transparency and access as envisioned by the Authority, nothing in the U.S. or U.K. experience supports the Authority’s conclusion that, in those circumstances, in-house matching inevitably leads to market inefficiency. We therefore have a fundamental concern that the Authority’s views are untested and could have unintended adverse effects on liquidity and competitiveness.

Transparency Is Just One of Many Factors That Contribute To Efficient Markets

A range of factors contribute to the “efficiency” (or, in the words of the Authority, the “adequate functioning”) of a market, including fairness, competition, liquidity, transparency, price stability, price formation and minimization of transaction costs. Some of these factors involve trade-offs. For example, increasing transparency may enhance “fairness” in the eyes of some investors but, in some markets, it may not be “fair” for other investors and may also reduce liquidity, result in higher transaction costs, and be a disincentive to the entry of new firms (competitors) into the market. Efficient markets are those that reconcile these conflicting demands in a way that maximizes the economic benefit to investors.

The Position Paper focuses on one of these factors – transparency – and treats transparency as an end in itself, rather than a means of achieving the ultimate objective of connection with rescission of New York Stock Exchange Rule 390 (the NYSE’s “concentration” rule) and the SEC’s solicitation of comments relating to market fragmentation.


5 See, supra, note 2. We are not aware of any market that requires participants to publicize all expressions of trading interest that they receive.

6 “Considering multiple facets of execution quality allows brokers to focus on the dimensions they believe customers value. For some investors, execution price is paramount. Others might desire the combination of commissions and execution prices producing the lowest net trading costs. Still others might be willing to forgo price improvement for immediate fills at predictable prices. Whether or not one venue offers best execution for all retail investors’ market orders is an empirical question that cannot be addressed focusing solely on execution prices.” “All Else Equal?: A Multidimensional Analysis of Retail, Market Order Execution Quality”, Robert Battalio, Associate Professor, University of Notre Dame; Brian Hatch, Assistant Professor, University of Cincinnati; Robert Jennings, Professor of Finance, Indiana University.
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an efficient market. In our opinion, this focus causes the Authority to overstate the benefits of pre-trade transparency and place too little weight on the potential adverse effects. We fear that, if pre-trade transparency is mandated, some broker-dealers that otherwise would engage in in-house matching may not be willing to assume the risk of making liquidity available to the market as a whole and therefore may decide not to provide in-house matching services to their customers. Mandatory order exposure also may destroy the incentives for markets to innovate and improve their services. Finally, we are concerned that mandatory order exposure may award market impact to even relatively small orders and thereby dramatically increase the costs of OTC trading of listed stocks. In each instance, investors are the ones who ultimately would be disadvantaged.

Conclusion

We are encouraged that the Euronext Amsterdam concentration rules have been abolished and that the Authority is considering other initiatives to eliminate market monopolies. Given this progress towards an open and competitive system, we believe that it would be a step backwards to allow the regulated markets to have a de facto monopoly.

We therefore urge the Authority to proceed cautiously with initiatives that could provide disincentives for competition and investor choice – particularly at the time when a proposal for the revision of the Investment Services Directive may soon be released. We would be pleased to answer any questions you might have and encourage the Authority to publish a feedback statement.

Sincerely,

[Signature]

David G. Strongin  
Vice President and  
Director, International  
Finance