Commentary: Europe Tries to Discourage Regulatory Arbitrage

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The SEC has been quite busy of late proposing new regulations for the equity markets, prompting eloquent and passionate responses from affected firms and organizations representing the trading community. There has been less rule-making activity for the vast and troubled debt markets, although the recent Asset-Based Securities proposal was a promising development.

On November 13, 2009, the SEC released proposed rules to limit the activities of dark pools by, among other things, requiring the public display of "actionable" indications of interest, which are currently not displayed by dark pools. On January 19, 2010, the SEC proposed new rules that would supersede the rules of self-regulatory organizations dealing with sponsored and naked access to markets and require broker-dealers to implement systems and procedures to control market access. On April 14, 2010, the SEC resurrected its long-dormant proposal to institute a large trader reporting system for NMS stocks. Last, but certainly not least, on January 14, 2010, the SEC published its Concept Release on Equity Market Structure, demonstrating its interest in adopting new rules that would regulate high frequency trading, exchange co-location activities, and further restrict internalization of orders by broker-dealers and dark pools.

In this new Age of Convergence, rule-making on the American side of the Atlantic is mirrored in Europe, and the SEC's equity market proposals are no exception. The purpose of convergence is to eliminate the incentives for a financial services firm to engage in "regulatory arbitrage" by locating where it can offer its services at the lowest regulatory cost.

So, on April 1, 2010, the Committee of European Securities Regulators (CESR) released a "Call for Evidence" on "Micro-structural issues of the European equity markets," largely imitating the SEC's most recent equity market regulatory initiatives. CESR is one of two committees established by the European Commission in response to the proposals made by Baron Alexandre Lamfalussy's Committee of Wise Men. Its job is to advise the Commission with respect to securities legislation. A Call for Evidence is more or less a concept release.

CESR's April 1 Call for Evidence deals with high frequency trading, sponsored access, co-location services, fee structures, tick size regimes and indications of interest. The comment period closed on April 30. Thirty-nine institutions made comments, roughly reflecting the views of four industry groups: (1) Banking, (2) Insurance, Pension and Asset Management, (3) Investment Services and (4)

Regulated markets, exchanges and trading systems. These categories reflect European regulatory systems. For example, banks include equity brokers.

As a general proposition, there were no serious disagreements among any of the commenters. Most thought that high frequency traders added liquidity and contributed to the narrowing of spreads, but should be monitored by regulators. There was general agreement that firms providing market access should have controls in place to prevent improper orders, but not for banning the practice. Co-location services were acceptable, provided they are offered on non-discriminatory terms at reasonable prices. Most commenters thought exchanges and alternative trading systems should be free to establish fee structures without restriction due to the competitive value of creative fee structures, but expressed concern about the potential for market disruption. Most argued that rates charged by exchanges and alternative trading systems should be publicly available. There was also agreement that tick sizes should be harmonized across Europe and that there was little need for smaller tick sizes.

Indications of interest sparked the most controversy.

Investment managers argued that IOIs were an important ingredient of customer choice. Tossing an insult, investment managers argued that they had no problem with high frequency traders, so long as they were not required to trade with them.

Proprietary traders fought back against the practice of "hidden" and "two-tier" markets. They argued that IOIs fostered a lack of transparency and should be treated the same as any other order and exposed to the public markets.

This controversy reflects the chasm that separates the European from U.S. market regulation. In the United States, the Exchange Act commands, and the SEC assumes as a first principle, that retail and institutional orders should interact. This concept has been difficult to achieve in practice. Every rule-making initiative intended to induce greater transparency for institutional orders has been resisted by industry-designed structures to avoid transparency. Dark pools are the most recent in a long history of transparency avoidance.

The SEC's equity market structure concept release is the latest and perhaps most ambitious attack on the citadel of non-transparency. Most regulatory efforts to induce greater transparency have foundered on the fact that broker-dealers are permitted to "internalize," which means they are permitted to execute client orders without first submitting them to the market. Advocates of dark pools and other anti-transparency structures have successfully made the case that it would be hypocritical to require the interaction of institutional and retail orders without outlawing internalization by broker-dealers. The concept release indicates that the SEC is now seriously considering the unthinkable -- proposals that would render internalization unprofitable. The adoption of these ideas in the form suggested in the concept release would effectively end the practice, as well as the last remaining source of profitability for equity trading desks.

European regulators, in contrast, generally believe that securities markets are best left to professionals and see no particular virtue in encouraging retail participation. As a result, there is no guiding principle in Europe that retail orders should interact with institutional orders. Transparency is regarded as a worthy goal in some situations, but not a first principle in Europe.

The cultural differences between Europe and the United States also means that while the European Commission may adopt securities regulations that, at first glance, appear to be consistent with U.S. regulations, they may be implemented in radically different ways. The maker-taker fee structure, for example, which pays liquidity "makers" a rebate, while charging "takers" for accessing the orders of makers, originally was intended to attract orders from retail day traders, competing with market makers who offered payment for order flow for retail orders. Institutional trading desks have never been as susceptible as retail desks to the blandishments of payment for order flow.

While Europe may institute flattering imitations of U.S. rules, actual convergence requires much more. Until an acceptable way is devised to bridge profound cultural differences, regulatory arbitrage will remain a profitable enterprise for financial services firms.