CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

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Alp Eroglu
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: Report on Order Routing Incentives

Dear Mr Eroglu,

CFA Institute appreciates the opportunity to respond to this consultation report on order routing incentives. CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 140,000 members in 150 countries and territories, including 133,000 Chartered Financial Analyst® charterholders, and 147 member societies.

CFA Institute believes that ensuring best execution requirements are adhered to is a critical part of maintaining market integrity, fairness, and investor protection. We have consistently[1] advocated[2] in support of regulatory efforts to ensure clients' interests are put first, while cautioning against regulatory changes that make markets unnecessarily complex. For example, we have commented on issues such as internalisation, segmented liquidity[3], order priority rules,[4] and their impact on the integrity of displayed quotations.

We appreciate the comprehensive and timely report on order routing incentives published by IOSCO and have found it useful as a global survey of best execution requirements and practices. We wish to contribute to IOSCO's consultation report by drawing your attention to several pieces of CFA Institute research on this issue, as well as related topics. CFA Institute has published a number of comment letters, position papers, and reports that may be informative to IOSCO as it finalises this report. We seek to draw your attention to these papers in the course of this letter. Specifically, we present the results of our 2016 study on the United Kingdom's Financial Conduct Authority (FCA) ban on payment for order flow (PFOF), as well as earlier CFA Institute studies on dark pools and internalisation which have relevance for order routing and execution practices.

The IOSCO report on order routing incentives discusses three primary issues:

- Monetary incentives received by brokers from third parties;
- Internalisation and the use of affiliated venues; and
- Provision of non-monetary goods and services bundled with execution by brokers.

[1] https://cfainstitute.org/learning/products/publications/commentletters/Pages/07032013_91342.aspx
[2] https://www.cfainstitute.org/learning/products/publications/commentletters/Pages/07202015_121490.aspx
[3] https://www.cfainstitute.org/Comment%20Letters/20111130.pdf
[4] https://www.cfainstitute.org/Comment%20Letters/20100106.pdf

The issue of monetary incentives received by brokers and their potential to influence order routing behaviour is of interest because these incentives may create a conflict of interest between the clients of the broker and the broking firm itself. Specifically, the incentive to achieve best execution for each trade for each client may conflict with the incentive to maximize fees from selling order flow to market makers. CFA Institute has consistently engaged on this issue through a mixture of regulatory outreach, as well as research. Of most relevance to this point is our 2016 study on the UK ban on PFOF arrangements. This study is discussed in more detail below; the results suggested that execution quality was not adversely affected by the ban on PFOF. This led us to conclude a simpler but equally effective market structure can be achieved as long as the various incentives at play are reformed in a holistic manner.

The second issue studied by IOSCO – internalisation and the use of affiliated venues – is of interest to CFA Institute because of our focus on market integrity and the potential for negative impacts from off-exchange trading. We are supportive of market structure innovations to the extent they further market fairness, market integrity, and/or investor protections. The increase in alternative trading venues and dark liquidity has enhanced competition and allowed for improved trade execution for institutional investors. However, these benefits are not linear, and continued growth in such off-exchange trading facilities poses challenges for overall market quality. Complex market structures can raise concerns around price discovery and increased adverse selection costs, requiring iterative regulatory amendments that can be slow to enact and, in turn, result in further unintended consequences. The findings of our 2012 research on dark pools, internalisation, and market quality inform our policy positions in this area, and are discussed in further detail below.

Finally, the IOSCO report looks at the provision of non-monetary goods and services bundled with execution by brokers. This is an issue that is pertinent in the UK and EU under changes to the MiFID II rules on inducements, in which payment for investment research will be unbundled from execution commissions. CFA Institute and CFA Society of the UK supports the removal of the explicit link between execution volume and research (thereby removing incentives to trade excessively)[5]. We also support moves to increase transparency and accountability over the use of client money to procure research, such as through greater use of research budgeting. As the exact mechanisms for implementing these rules are developed, it will become necessary to focus more on the value of research. To that end, CFA Society of the UK and CFA Institute co-sponsored a report on investment research valuation approaches, which sets out a variety methods to help firms value and price investment research.[6]

Having broadly outlined our positions on the three main issues discussed in IOSCO's report, we wish to present in more detail the findings from the research that informs our response.

CFA Institute Study on UK ban on Payment for Order Flow (PFOF)

The incompatibility of PFOF with best execution obligations was emphasised by the Financial Services Authority (FSA) in 2012 (replaced by the FCA in 2013) and provided an opportunity to study the state of the UK market before and after the ruling prohibiting PFOF arrangements in the UK.

We analyse the proportion of retail-sized orders executing at the best quoted price on the UK's primary market – the London Stock Exchange (LSE) – before and after the FSA's updated guidance in May

[5] See CFA Society of the United Kingdom paper on "The Market for Research", available at https://www.cfauk.org/professionalism/research-and-position-papers

[6] See CFA Society of the United Kingdom, *Investment Research Valuation Approaches: A Framework and Guide for Investment Managers and Asset Owners,* available at https://secure.**cfauk**.org/assets/2670/0914___**Research**Valuation___web.**pdf**

2012. In the paper, we posit that the explicit removal of a potential source of revenue for brokers (and with it, a removal of potential agency conflicts) should lead to more efficient order-handling practices and a more competitive market for retail-sized orders. In addition to the prohibition of PFOF, the coincident growth of lower-cost internet execution-only accounts, and the limited profitability for brokers of servicing retail clients, may cause the U.K. retail equity market to become a more competitive, utility-like service.

Our empirical results show an increase in the proportion of retail sized trades executing at best quoted prices between 2010 and 2014 from 65% to more than 90%, which is consistent with our hypothesis. It is noteworthy, however, that this increase is largely at the expense of trades executed with price improvement, However, at the same time, quoted spreads narrowed for large-cap stocks between 2010 and 2014 (small-cap spreads were little changed). In particular, the quoted spread for large cap stocks for trades executed at the best price narrows from 6.8 bps in 2010 to 4.6 bps in 2014. Consequently, the potential savings to retail investors from trades executed with price improvement are markedly smaller after the PFOF ruling, with better touch prices for all investors. The implication is that without PFOF, and coincident with the continuing growth of internet execution-only accounts, the market has become more efficient and utility-like (the price you see is the price you trade at).

We believe this is a positive change for market integrity as it implies that displayed liquidity providers are rewarded with executions at the price they quote. This reward mechanism upholds market integrity because it supports the incentive to post displayed limit orders – upon which price discovery is based. In turn, this should lead to more aggressive quoting and competitive pricing. By contrast, this outcome may be jeopardized in markets with PFOF where internalizers are able to step ahead of the quoted price on the order book by offering price improvement. It appears that the current best execution regime in the U.K. is working well, despite the lack of a US-style trade-through rule that explicitly prevents executions away from the best quoted price.

Study on dark pools and internalisation

CFA Institute is interested in undisplayed or 'dark' trading away from public exchanges because of its mission to promote market fairness, integrity, and investor protection. Many of our members have raised concerns that the incentive to display orders in public markets may be undermined by off-exchange trading. In 2012, we undertook a study[7] to determine whether off-exchange trading was beneficial to market quality, using several measures such as bid-offer spreads and top-of-book market depth to measure market quality.

In a related paper[8], published in the Financial Analysts Journal, we examine 450 US stocks, including both small and large capitalization stocks, and find that dark venue trading is beneficial for quoted spreads up to a certain level (around 12-19% market share for large caps and 45-60% for small caps). We argue that the increase in market competition afforded by the regulatory-driven fragmentation of the equity market has benefits for investors but that after a certain share of trading volume, dark trading becomes harmful to investors' interests.

Sponsored study on regulatory efforts to reduce dark trading

CFA Institute regularly contracts with academic researchers to produce thought leadership content on certain topics that are of interest to members, policymakers, and industry stakeholders. In 2014, we

[7] https://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2012.n5.1.aspx
[8] http://www.cfapubs.org/doi/abs/10.2469/faj.v70.n6.2

commissioned a report[9], authored by Sean Foley (University of Sydney) and Talis Putnins (University of Technology Sydney and Stockholm School of Economics) on regulatory efforts to reduce dark trading in Canada and Australia. In both jurisdictions, regulators implemented rules requiring dark trades to provide meaningful price improvement relative to the best displayed quotes. The results show that the new rules decrease the amount of dark trading by around one-third, and broker internalisation is reduced as well. Despite this apparent success, the authors argue that the regulation did not achieve its ultimate goal of improving market quality because there is no observable increase in the propensity to post displayed quotes, and spreads increased.

Concluding Remarks

CFA Institute believes that price transparency is critical to well-functioning markets. Our policy positions on market structure issues reflect this belief. We have expressed our support for increased equity market competition but cautioned that the benefits of dark trading venues are finite; we have shown that jurisdictions where payment for order flow arrangements are banned can achieve good best execution outcomes; and we have advocated on numerous occasions for maintaining the integrity of displayed quotes in the interests of ensuring exchanges fulfil their function in facilitating price discovery.

We welcome the opportunity to comment on IOSCO's work on order routing incentives. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

Sviatoslav Rosov, PhD, CFA
Analyst, Capital Markets Policy, EMEA
CFA Institute

+44 20 7330 9558
sviatoslav.rosov@cfainstitute.org

Rhodri Preece, CFA
Head, Capital Markets Policy, EMEA
CFA Institute

+44 20 7330 9522
rhodri.preece@cfainstitute.org

[9] https://www.cfainstitute.org/ethics/Documents/Policy%20Brief_Trade-at%20Rules.pdf