FIA EPTA
EUROPEAN PRINCIPAL TRADERS ASSOCIATION

14 March 2022

FIA EPTA response to the IOSCO Consultation Paper on Operational resilience of trading venues and market intermediaries during the COVID-19 pandemic

Introduction:
The European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the IOSCO Consolation Paper on the Operational resilience of trading venues and market intermediaries during the COVID-19 pandemic.

FIA EPTA represents 26 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are authorised as MiFID II investment firms in the Czech Republic, Germany, Ireland, The Netherlands, and the UK.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and to end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

FIA EPTA members believe it an important step by IOSCO to review the resilience of financial market participants during the Covid-19 pandemic as the lessons learned will better prepare the sector for future occurrences of high volatility. We would welcome the opportunity to provide further background to IOSCO on the issues raised in our response.

Question 1: In the context of reviewing operational resilience during the pandemic, is the description of 'operational resilience' and 'critical operations' appropriate for:

(a) **trading venues;** FIA EPTA members agree with the description by IOSCO.

(b) market intermediaries? FIA EPTA members agree with the description by IOSCO, but do want to emphasise, which is also mentioned by IOSCO in the consultation paper, that for market intermediaries there exists greater diversity between firms. This needs to be taken into consideration when reviewing the resilience during the pandemic as it is not a one size fits all category.

If not, please explain why and describe your preferred approach?
Not applicable.

Question 2: Are there other impacts, risks or challenges faced by regulated entities not mentioned in this section?
FIA EPTA members agree with the IOSCO assessment of the risks and challenges faced by regulated entities in the consultation paper. However, FIA EPTA members consider there to be additional risks and challenges that are not being mentioned in the consultation.

Short-selling bans:
At the start of the Covid-19 pandemic, several European regulators chose to implement short-selling bans. The purpose of the short sell bans was communicated as seeking to address the "serious threat to market confidence and financial stability"[1]. The short-sell bans were implemented to counter the expected extreme price movements (high volatility) and low liquidity (wide spreads).

As FIA EPTA members we recognise the challenges that authorities globally faced in responding to the unprecedented disruption associated with COVID-19 and we are aware that in the regulatory community there is not a common view on the role (including possible downsides or upsides) of short-selling in financial markets. However, market data on securities subject to the restrictions which were put in place in various European countries shows that securities under a ban were not collectively performing better than those in comparable jurisdictions that were not subject to restrictions; shares were more volatile than they were prior to the bans; markets exhibited wider spreads as a result of restrictions being put in place.

These findings reflect the long-recognised important role that short selling plays in financial markets, bringing liquidity and checking downward price pressures as short sellers cover their positions. Banning short selling significantly degrades market liquidity and price formation, while increasing trading costs and volatility, something borne out by past academic research.

Wider spreads also mean higher costs for investors and therefore poorer returns. These investors include pension funds and endowments looking to save for the future and manage risk on behalf of citizens.

[1]"ESMA issues positive opinion on short https://www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-french-amf.

Over the longer term, such bans risk undermining confidence in key financial markets and hampering their ability to support the recovery and growth of the wider economy. Market confidence was further damaged by the observed lack of coordination regarding how bans were implemented. While we welcome the efforts by the European Securities and Markets Authority (ESMA) to standardise certain elements of the various bans, the initial lack of coordination among European public authorities caused significant market disruption and in our view illustrates the need for a reassessment of using short selling bans as a policy tool as well as for significantly improved coordination given the cross-border impact of short selling bans.

We would encourage IOSCO to work with its members on reassessing the use of short selling bans, taking into account the analytical data showing that short selling restrictions have not been effective in delivering greater market stability. In this regard, we would also point to the research undertaken by FIA EPTA itself following the start of the Covid-19 pandemic:

In two research papers[2], FIA EPTA examined short-sell bans in Europe: the first paper compared four indexes (BEL-20 (Belgium), CAC40 (France), the FTSE MIB (Italy) and the IBEX 35 (Spain) which implemented a short-sell ban and three indexes (DAX 30 (Germany), AEX (Netherlands) and the FTSE 100 (UK) which did not implement a short-sell ban. The conclusions were clear: the short-selling ban had no discernible impact on levels of volatility. The second paper compared individual French and German stocks. This research found that after the short-selling ban French stocks had much wider spreads than their German equivalents, resulting in higher costs for market participants. When looking at volumes, we found that French stocks dropped more than their German counterparts suggesting lower market confidence and credibility after the ban was introduced. FIA EPTA members believe that the short selling ban had no positive impact on the market. Instead, it prevented participants from trading effectively and pricing accurately. We strongly believe that markets are healthier without the introduction of short selling restrictions.

In light of the now extensive body of research showing that banning short-selling does not achieve its intended outcome therefore and can indeed have unintended harmful consequences for markets and investors, FIA EPTA members would urge regulators to reconsider any rush to impose short-selling bans in future times of crisis on (European) financial markets.

Issues with dividend uncertainties

FIA EPTA members also encountered issues with uncertainties with listed companies' dividend policies at the start of the Covid-19 pandemic. In that context, we also would like to share the FIA EPTA analysis on the impact of dividend announcements during the COVID 19 crisis on option spreads.

[2] FIA EPTA published two analyses of the impact of the short-selling bans in April 2020: https://www.fia.org/epta/resources/fia-epta-issued-two-analyses-impact-short-selling-bans.

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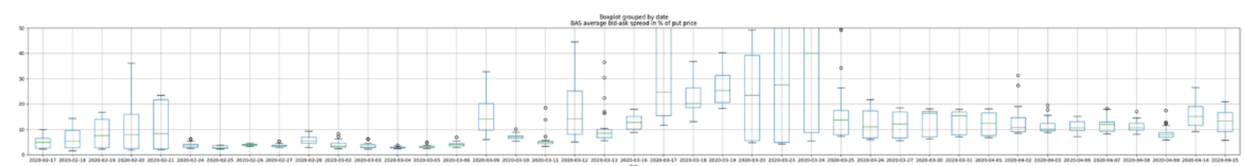
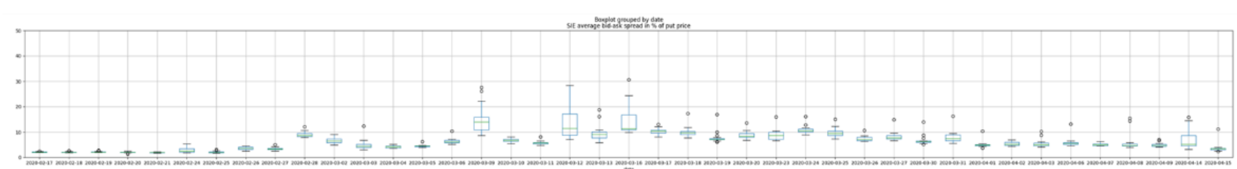
FIA EPTA members note that dividend uncertainty impacts the equity option spreads but is very difficult to decipher given the stock/sector/macro news that also impacts this heavily, in addition to the increased volatility in general which has an impact on the spread.

The below graphs are based on the public market data. They show two equity options (at-the-money puts for BASF and Siemens), which are under normal conditions comparable in terms of volatility. Dividend uncertainty became relevant for BASF from the 17th of March onward, and a clear increase is visible in the spread for this strike. The spread was widening to 50% of the price of the instrument whereas Siemens, without dividend risk, had a stable width of around 10%. The average bid/ask spread in Siemens stayed well below 10% in the weeks that followed, whereas BASF now with dividend uncertainty had an average spread of around 25% of the price initially and in the 10-15% range in the weeks that followed. It is clearly significantly wider compared to Siemens and a lot wider on average compared to the end of February/start March.

Given these important impacts, we believe it is essential that price-sensitive information regarding corporate actions (such as dividend changes or cancellations) are publicly communicated in a timely and coordinated fashion, including considering the impact of such announcements on exchange-traded derivatives. It is our impression that this was not always the case during the recent COVID 19 crisis and would suggest that this may require further attention by regulators, including IOSCO.





Question 3: Are there other impacts, risks or challenges from remote work or hybrid working that impact operational resilience?

The start of the Covid-19 pandemic created many challenges for firms to operate remotely or hybrid, with the pandemic impacting markets, physical trading floors closed and liquidity diminished and volatility grew. FIA EPTA members believe that the industry was well prepared for such a scenario and adapted well to changed circumstances and created new partnerships and opportunities which increased resilience.

Research by Redlap Consulting[3] showed that at the start of the pandemic some sell-side firms opted to withdraw from trading certain segments. The buy-side had to search and engage with new sources of liquidity to continue trading, these partnerships were found including with Electronic Liquidity Providers (ELPs). As electronification is moving across the asset classes (including fixed income), the post-pandemic markets landscape in Europe creates an opportunity for more diverse actors to become incorporated into the trading process. Asset managers are looking to benefit from a wider and more diverse pool of counterparties and create greater optionality in how and where they can execute investment strategies.

FIA EPTA members believe this is an important development for the European market infrastructure and a positive outcome since the start of the Covid-19 pandemic. The research by Redlap Consulting found that for 91% of respondents, the electronification of equity markets since the implementation of MiFID II in 2018 has delivered a more robust market infrastructure, enabling a high level of self-sufficiency for the buy-side compared to the financial crisis of 2008. At that time, buy-side firms were heavily dependent on traditional providers of risk capital.

The results showed 77% of respondents increased their means of accessing liquidity electronically and automated trading during the pandemic. Years of regulatory reforms combined with greater automation of equity workflows have made asset managers more self-sufficient in how they source liquidity and from whom. In the 2018-2020 period the buy-side benefitted from greater use of electronic trading and algorithms with access to more diverse venues. This provided them with the ability to access the liquidity they needed to trade even when the provision of traditional risk capital dried up. FIA EPTA members anticipate that buy-side participants will maintain strong relationships with bulge bracket banks for access to a broad range of services including primary allocation. However, in an environment of chronically constrained liquidity, maintaining greater optionality over how to access liquidity became essential. The pandemic lifted the veil on the role other types of liquidity providers, including ELPs can play in liquidity formation, with 70% of participants in the research acknowledging they engaged more with non-bank market makers during the volatility, with some emphasising the ELP model as a particularly good match for specific products or fill requirements. In addition, 53% of the interviewees noted that they are actively seeking alternative counterparties to guarantee future access to liquidity regardless of trading conditions.

FIA EPTA members believe this is a very positive trend in the European market infrastructure and it will create greater operational resilience for future market fluctuations. Liquidity is expected to remain the most important criterion for asset managers to select brokers across asset classes. The role of technology will only continue to increase to determine when, where and how to source liquidity in order to deliver best execution for end investors – wherever that resides. Innovation will continue to reshape the execution landscape, moving buy-side dealing desks from passive recipients of sell-side liquidity to active participants building latent liquidity. We would expect the key differentiator for the liquidity providers of the future will be their ability to provide greater multilateral access allowing the buy-side to move away from the traditional siloed approach to trading asset classes and take greater ownership of execution irrespective of the asset they are trading.

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[3] Redlap Consulting, Rebecca Healey & Charlotte Decuyper, *Liquidity in the Time of Covid: Building New Liquidity Partnerships - The View from the Buy Side*, September 2021: https://wearemarketmakers.com/liquidity-in-the-time-of-covid-download-the-report/.

Question 4: Are there other lessons learned that can be drawn from the experiences of regulated entities during the pandemic in the context of maintaining operational resilience?

<u>*Exchanges outages*</u>

During 2020 European market infrastructure was hit by multiple outages, which came during a time of already existing uncertainties due to the Covid-19 pandemic and many firms still adapting to working from home/hybrid policies. FIA EPTA members believe that there should be an improvement in the communication from trading venues to the market at large in the case of system or trading outages. The trading outages in 2020 (as well as those that occurred previously) highlighted varied communication protocols and standards across trading venues, which further exacerbate the disruption to the market caused by the outage in the first place.

FIA EPTA members believe that the need for these communication improvements continues to grow as European exchanges continue to consolidate. This consolidation leads to more widespread effects of an outage, as single trading systems operate on many markets simultaneously. During outages at incumbent exchanges, trading should continue on the alternative available MTFs

FIA EPTA does not believe that there should be one prescriptive format for communication but rather that there should be a set of minimum standards in place for all trading venues for handling and communicating a trading outage that would include the following minimum standards:

Pre-established procedures

- A crisis management team should be established at each trading venue. This crisis management team would be responsible for communications around outages to all stakeholders as well as maintaining the venue's crisis playbook. This also includes having a crisis governance framework in place to enable straight and clear decision-making processes by management upon requests from market participants or other stakeholders. Delayed decision making, for instance on market making obligations or liquidity provisions, that harms the efficient operation of the market should be avoided under extreme stressed conditions.
- All trading venues should develop and publish a playbook for what will occur if or when an outage takes place.
    - The playbook should clearly identify the mechanisms and locations (websites, protocols) for dissemination of information to stakeholders regarding the outage.
    - It should be clear what information these channels will include and in what format.
    - In addition, there should be protocols for identifying, diagnosing and resolving issues and halting and restarting trading including a minimum notification time.
    - Playbooks should outline different scenarios in which exchanges will or will not re-open and establish clear procedures for re-opening.
    - Trading venues should also define a procedure to determine the market closing price in the event where the market cannot reopen.

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During the outage

- Trading venues must be proactive and clear in their communications, giving stakeholders as much detail as is known, as soon as it is known, without speculation.
- Ideally, communications regarding market status should also be in a machine-readable format, available on exchange connectivity and market data protocols, so that trading systems can automatically incorporate these notifications into their procedures, where relevant.
- All communication regarding the ongoing health of a venue's trading system and details about possible outages should also be made publicly available to all interested parties and hosted in a central location, for instance on a defined webpage.
- These communications should be updated on a fixed schedule, for instance, every 15 minutes, giving a status update, even if the update is "no update".

Status of orders

- At a minimum, any market statuses, instrument prices, outstanding order statuses, and trade feeds published by trading venues on their execution or market data feeds must be accurate and consistent during an outage, and not lead participants to believe the venue is operating in a normal state. A special outage or closed status can aid this.
- This market data notification regarding status is essential for the market to know without a doubt that there is a technical issue on the market, which can in turn trigger participants' automatic redundancy plans and allow participants to decide whether or not to continue trading elsewhere.
- Trading venues should make public the specific time stamps at the point at which orders were cleared and/or rejected and which trades were considered valid. This should be done as soon as is feasible.

Reopening

- Any planned re-opening times should be published on this central location. Re-opening times should be communicated clearly to the market at least 20 minutes prior to opening and re-open on a "round" time increment (e.g., on the hour or half-hour).
- Trading venues should consult with participants on whether to re-open to ensure there are no outstanding issues which might be further exacerbated by the market re-open.
- When a venue restarts it should open in a manner which avoids dependency on the primary opening and causes minimal disruption to trading.

After an outage

- Trading venues should provide all stakeholders and members with a comprehensive post-mortem analysis and follow-up points after any major incident, which should include disclosure of the root cause and the steps taken to rectify and prevent a recurrence.
- Outages will happen. Venues should be judged on how well they handle those outages.

FIA EPTA members believe that these communication standards should be applied to cases where an incident affects trading as well as cases where it does not but could have had a large impact. Coordinating this properly simply takes time. FIA EPTA believes that it is in the best interests of the market and of orderly trading for the appropriate amount of time to be taken to properly resolve an incident and to restart afterwards, instead of forcing trading venues to adhere to an arbitrary two-hour restart deadline.

Forcing haste in such matters will often lead to further issues later on, which was apparent in at least one of the exchange outages in 2020.

FIA EPTA members note that the wider market would be better served by improved resilience across the system as a whole, with true alternatives to primary listing markets (or any individual venue), rather than a specific and arbitrary focus on restart times. This focus on improvements on resilience is also important when they would have happened during the height of the Covid-19 pandemic and the consequences could have been even more severe.

The Current Exposure Method and the adoption of SA-CCR

An issue that FIA EPTA members encountered during the start of the Covid-19 pandemic were the regulatory constraints for clearing firms offering client clearing services to options market makers. While the issue was subsequently resolved as a consequence of regulatory change, FIA EPTA members still would like to highlight this as it created a constrained situation at a time of high volatility and it stood in the way of supplying much-needed liquidity when it was most needed.

In March 2020, clearing banks were significantly constrained in providing clearing services to options market makers as a consequence of having to apply the Current Exposure Method (CEM) for calculating counterparty credit risk of clients for the purpose of the Leverage Ratio. In the highly volatile market environment at the start of the pandemic, the CEM was constraining options market making in an even more negative way than was already the case, punishing options market makers for maintaining hedged inventories.

CEM-induced inventory reductions (i.e., closing down positions) carried the unintended consequence of forcing market makers to effectively become market takers thereby creating price distortions. This would have obviously greatly hurt market liquidity and exacerbated volatility as end-investors would have been prevented from risk managing their exposures and protecting their portfolios using exchange-traded options, while also exposing them to adverse price movements.

The darkest scenario, fortunately, did not become a reality as a consequence of a relative easing of market conditions following the initial very significant volatility. However, it was a close call and relief for this issue was only found as the Standardised Approach for Counterparty Credit Risk (SA-CCR) method ultimately became available to European clearing banks as an alternative to CEM.

However, this episode clearly indicates in our view the importance for ensuring that potential second-order impacts on securities markets functioning are more seriously taken into account when designing and calibrating prudential requirements. In this regard, we believe securities markets regulators, including IOSCO, could play a stronger role in informing the prudential regulatory policy formation process, so as to prevent the implementation of unduly procyclical requirements.