WORLD FEDERATION OF EXCHANGES

Response: Calibration of equity block-trade size in Brazil (CVM Resolution 135/2022) – July 15th, 2022

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent the operators of over 250 market infrastructures, spread across the Asia-Pacific region (37%), EMEA (43%) and the Americas (20%), with everything from local entities in emerging markets to international groups based in major financial centres. In total, member exchanges trade around $100 trillion a year and are home to some 60,000 companies, with an aggregate market capitalisation of around $120 trillion. The 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to invest, raise capital and manage financial risk.

Founded in 1961, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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CVM Proposals for defining a minimum size for equity block trades in Brazil

July 15th, 2022

We welcome the opportunity to respond to CVM's proposals regarding the calibration of block-trade size in the Brazilian equity markets. We agree that block trades are a useful component of secondary equity markets. We further agree that the threshold for blocks in equity markets should be set in relation to average daily trading volume (ADTV) over a representative period, such as a year.

We do, however, also believe that the calibration should be set with a view to broader outcomes, in terms of market structure and price formation within it. In particular, we consider it important to the interests of the secondary market in equities as a whole, whether traded as blocks or otherwise, that the core price-formation process be adequately maintained and supported; and that the process be seen to be maintained.

As currently calibrated, this would not appear to be the case. As regards the institutional market, for which equity block trades would be most relevant, analysis by the exchange shows that nearly 80% of directional trades by this sector would have been eligible to be counted as blocks in the past, if the proposed thresholds were to have applied. (By 'directional' trades, we mean those buys or sells that are not reversed within the day. Figures from the exchange show that R$10.1bn out of R$12.8bn of directional equity trades by institutional investors would have counted as blocks under the proposed rules.)

Given that such block trades would benefit from reduced market-transparency requirements, potentially removing 80% of directional trades from the institutional flow – which is 'informed' flow, whose presence may be especially important to perceptions of market integrity – would represent a significant reduction of volume available to the core formation of reference prices in equities.

At the same time, Brazilian secondary equity markets already seem to be performing well. On-exchange trading volumes in Brazil have increased strongly in the past six years, going from an ADTV of R$5 billion in January 2016 to nearly R$30bn in 2022. This suggests that the Brazilian secondary market in equities has been well served by a centralised venue. Institutional participants consistently make up between a quarter and a third of the volume, contributing a significant part of the functioning of the market in general and price formation in particular. This is accompanied by strong participation from retail investors (accounting for between 15% and 25%).

The WFE believes in competition venue. We also believe, however, that this should be framed in a way that does not introduce new issues in terms of transparency of prices. This could be counterproductive at a time when other major jurisdictions – notably the US[1] and the EU[2] – are paying close attention to issues with segmentation and markets within markets.

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[1] SEC Chair Gensler speech, 8th June. "Markets have become increasingly hidden from view. In 2009, off-exchange trading accounted for a quarter of US equity volume. Last year, during the meme stock events, that share swelled to a peak of 47%…. It's not clear, with such market segmentation and concentration, and with an uneven playing field, that our current national market system is as fair and competitive as possible for investors."

[2] The MiFID review process is paying particular attention to issues of lit versus dark trading.

In light of this, we suggest that the calibration of the equity block size be done such that a meaningful portion of the institutional market be preserved for the core price-formation process, given that the market already functions well, in terms of consistency and growth of ADTV.

We recognise that block trading per se can serve a useful purpose. It does, however, depend in practice on an effective primary process of price formation, which in equities will typically entail the operation of a central limit order book (CLOB). The relationship should be symbiotic and sensitive to the state of the order book from time to time, rather than an 'either-or' proposition, or functioning in a way that could ultimately reduce confidence in the core price formation process. That would be detrimental not just to the operator of the CLOB but to the market as a whole.

It is noteworthy that a similar debate happens in relation to dark trading, where it is generally recognised that information efficiency decreases once the proportion of dark trading rises above 10-15%.[3]

We would add that retaining volumes within central infrastructure is particularly desirable where this means that central clearing will apply. The benefits of central clearing are well known and, even where netting benefits are not especially high (as will be the case where directional trades are involved) the increased robustness of the system is still important.

[3] See Comerton-Forde and Putnins (2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2183392