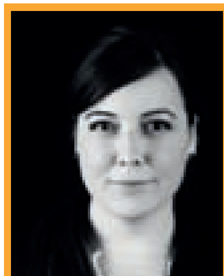
The Future of Financial Trading Transparency



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The last 30 years have seen dramatic changes in financial trading. Exchanges that previously featured loud and vibrant trading floors are now much quieter digital spaces, and over-the-counter (OTC) trades once handled on the phone are today routed to electronic quotation and trading systems. Those who embraced computer-assisted trading early on, like Interactive Brokers founder Thomas Peterffy and Bloomberg co-founder and former New York City Mayor Michael Bloomberg, have come out as clear winners of this change.

Technological innovation has taken the depth and sophistication of financial markets to unprecedented levels. It has increased competition by removing geographic barriers and allowing real-time data access and continuous multilateral interaction. It has permitted much higher volumes to be handled much more cheaply and at much higher speed, and in customized ways that would have been impossible or too expensive before. It has let traders, many leveraging algorithmic trading, to generate fair prices and control risk more efficiently than previously imagined. In theory, at least, it has helped create data trails that regulators can follow when suspecting illegal activity. No wonder that CEU's professional MSc in finance guided by industry dedicates an entire course to financial trading design and technology, and runs a fintech dual degree with the MSc in technology management and innovation.

With all the benefits of having technologically sophisticated financial markets, their functional weaknesses and opaqueness now driven by their complexities were laid bare by the financial crisis. A key concern has been off-exchange OTC trading, and especially "dark pool trades" enabled by the fragmentation of trading venues. Dark pool trades are offered away from the public trade feed through crossing networks and private arrangements. Since they are unreported until sometime after they have been filled, they do not show up in real-time price formation. They still contribute to price discovery if incorporated into a post-trade transparency regime, since many of these trades would not have been made in a lit market. Nonetheless, regulators are stepping up over fears of opaqueness and predatory behavior. In the United States, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have both implemented measures to lighten dark pools. Barclays, Credit Suisse and UBS have all been fined.

New Rules

The European Commission's response has been new securities market rules that entered into force in 2014: MiFID II, the update of the 2004 Markets in Financial Instruments Directive, and MiFIR, the Markets in Financial Instruments Regulation. From 2018, the MiFID I transparency regime for shares will be extended to other equity-like instruments and non-equities including bonds, derivatives, structured products and emission allowances. Both pre-trade and post-trade transparency rules will apply, with trading interests and price quotes disclosed upfront, trading caps, and executed trades published near real-time. Post-trade rules will apply to trades outside regulated trading venues and institutions that qualify as so-called systematic internalizers. Many of the provisions are subject to waivers, exemptions, shortcuts and even interpretation. But the list goes on and the objective is clear.

MiFID II and MiFIR are certainly a step in the right direction in lightening dark pool trades, but the potential effects remain unclear. It may redirect trading back to exchanges in exchange-listed shares and other instruments that have seen a surge in off-exchange OTC trading. However, there are concerns that small players will be driven out by the cost of compliance, leading to even more oligopolistic markets. Many also expect a negative impact on issuers in European bond markets. On one hand, market makers may widen sell-side quotes in a primary market where pre-trade prices and trading interests must be disclosed. On the other, the Financial Times points out in a May 19 article that deals may be firewalled from retail investors due to new risk disclosure rules.

It also remains to be seen how smoothly the implementation of MiFID II and MiFIR will go. It was originally scheduled to apply from **2017,** but the European Securities and Markets Authority (ESMA) and national authorities including the National Bank of Hungary could not install essential data infrastructures in time.

This column is part of a series of opinion pieces from experts at the CEU Business School in Budapest. The opinions stated here do not necessarily reflect those of the BBJ.