

## FinReg Forecast: Nine Market Structure Predictions for 2012 | Jamie Selway



At the intersection of markets and technology, Insights provides ITG's global perspectives on market structure, analytics and research, and liquidity.

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As we enter the New Year – with hopes of better volumes and a bounce for our industry – we provide our annual list of market structure predictions below. Next, we mark the book on 2011's blotter.

**1. Tobin Tax Flirtations Fail.** In the second half of 2011, one of the worst ideas lurking around financial markets – the “Tobin tax” on transactions – resurfaced in both the EU and US. While not new, the combination of revenue shortfalls in the face of growing obligations and populist appeals to residual anti-banker sentiment makes the danger clear and present to the industry. In the EU, the proposed Financial Transactions Tax comes close, but is ultimately rejected. In the US, the efforts of Congressman DeFazio and Senator Harkins generate election year buzz, but aren't seriously considered. We close 2012 with no new taxes of this type on the global books.

**2. Ex-CAT, a “Nothing Done” at SEC.** As the SEC completes its docket of post-Flash Crash rulemaking – limit up/down and market-wide circuit breakers – it turns to an imposing list of Dodd-Frank to-do's. Then the approach of the presidential election brings about the usual Washington slowdown. The result: aside from approval of its Consolidated Audit Trail proposal, the SEC engages in no major equity market structure business. Moreover, by year end, at least one – and perhaps both – of SEC Chairman Shapiro and CFTC Chairman Gensler have moved on from their respective agencies.

**3. DirectEdge Trades.** As EU authorities lean on NYSE Euronext and Deutsche Borse for derivatives-related concessions and render the deal less and less likely, the US Department of Justice's required remedy – divestiture of DirectEdge – happens regardless of the final outcome. Lost in the corporate tangle at Deutsche Borse (via Eurex) and possessing international aspirations of its own, DirectEdge management successfully argues for a sale of Eurex's 31.5% stake. The buyer is a foreign exchange in search of a US beachhead, as opposed to a domestic exchange or a consortium-minded group of market participants.

**4. Maple-TMX: All Sap, No Syrup.** Financial markets opened 2011 with a burst of exchange merger euphoria redolent of the “go-go” years of 2006 and 2007. Alas, regulators around the world pulled the punch bowl, leading to multiple failures and a single success (BATS-Chi-X Europe). In Canada, the Maple Acquisition Group – a consortium of thirteen large financial institutions, including four of the “big six” banks – launched a hostile offer for TMX in competition with the LSE. While the price may be right for TMX shareholders, regulators claim another scalp towards the end of Q1. Specifically, the Canadian Competition Bureau (CCB) intervenes, based on its discomfort with a potential (near) monopoly in equity listings, equity trading, equity clearing, fixed income clearing, derivative clearing, derivative trading, and equity trading data distribution (whew!), which would be created by the combination of TMX and Maple's members stakes in Alpha (an alternative marketplace) and CDS (an equities and fixed income clearinghouse).

**5. An Exchange Launches Spot FX.** With the many negative headlines around its current custodian-centric market structure and lack of basic transparency, an increasing number of experienced electronic trading hands view FX as the “next big thing.” Although a handful of banks are at

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work modernizing FX approaches to meet equity-like standards, and HFTs have begun trading FX in earnest, exchanges currently only have a role on the futures side. While the clearing issues aren't straightforward – there's no DTCC-style central counterparty in FX, just the bank-dominated CLS – an enterprising and intrepid exchange changes the landscape by launching a spot trading initiative.

**6. An HFT Files an S-1.** Over the past two or three years, much time and energy has been spent in an effort to define, if not understand, the high-frequency trader. These informational clouds part in 2012, as a large, mature HFT prepares for an initial public offering by filing an S-1 – the “holiest of holies” of business descriptors. Interested readers find what discerning market participants have known for a while: HFTs trade for tiny edge, deploy modest capital, and do not warehouse risk. More “exchange error account” than market maker of yore, the industry and public's fear and loathing of HFTs decreases with each bit of incremental transparency.

**7. Alternatives Accelerate in Asia-Pacific.** While the US and EU spent much of 2011 in a state of market structure stasis, Asia-Pacific provided positive indications for the growth of alternative trading venues to traditional exchanges. This trend accelerates in 2012. By year-end, three important milestones are reached: PTSs account for 12% market share in Japan, Chi-X reaches 5% market share in Australia, and South Korea provides a regulatory framework for a competitor—either exchange or broker-sponsored dark pool—to KRX. Further, a third marketplace files with ASIC to join the Australian fray. Legacy exchanges continue to respond—also at accelerated pace — to these threats via investment in technology and corporate combinations. More lunch-hour breaks go the way of the teletype machine.

**8. Brazil to Competition: “Boa Vinda.”** Institutional investor interest in Brazil continued to grow in 2011. Alas, Brazil remains an expensive place to trade, particularly in size. In December, Brazil's Finance Ministry ended its 2% IOF tax on equities, clear progress towards better, cheaper trading. Next year, Brazil's securities regulator, CVM, adds fuel to this fire by allowing competition to Bovespa. As usual, clearing is the sticky wicket, but imposition of an “open access” policy provides the path forward. DirectEdge and BATS have been outspoken about their appetites for a Brazilian business. More aspirants join them in 2012. While no competing marketplace launches in 2012, we end the year with a date certain and a good deal of investor interest.

**9. ETFs Get Guardrails.** On the back of both regulatory and political attention—not to mention considerable scapegoating for the high levels of equities volatility and correlation and poor condition of the equities business generally—the exchange-traded fund industry began to organize its defense last year. This proves timely, because policymakers spring into action in 2012. Globally, regulators formally define the term “ETF,” with the consequence that complex, derivatives-based products need to find a new acronym. In the EU, regulators push for hard and fast standards for swap-based products, such as a minimum number of counterparties and guidance around acceptable collateral. In the US, regulators explore the effect of the ETF boom on market quality and propose to replace the current “no action letter” method of registration with an ETF-tailored approach.

**2011 Predictions Scorecard.** Shorts of our crystal ball were rewarded handsomely last year. By our lights, we were correct on two, wrong on four, and pushed on two. On the plus side, with the help of the industry, the SEC is on the cusp of replacing single-stock circuit breakers with a “limit up/down” approach and updating the existing market-wide framework. Exchanges challenged internalizers last year in a few ways, most prominently NASDAQ's aggressive taker/maker rates on BX and NYSE's proposed RLP program. We score our HFT call a push – the 2011 trading environment was definitely a speed bump, particularly May's reverse Citigroup split, but regulators took no decisive HFT action and exchanges did not move on cancellation-related taxes. And while NYPC



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launched and made modest progress vis-à-vis CME in Eurodollars, ELX and IDCG end the year “unch’ed” in terms of ownership.

In terms of misses, the SEC neither extended its Market Access Rule to algorithms nor approved its Consolidated Audit Trail proposal – whether in slimmed-down, realistic form (read: no real-time data requirement) or otherwise. On Dodd-Frank implementation, the CFTC has made the most progress of its regulatory brethren by a wide margin, but many rule approvals came late in the year or remain for early 2012, and its new position limit scheme is headed for the courts. Our near-sightedness was again evident where dark pools are concerned, as we got it precisely backwards on minimum order size outcomes in Canada and Australia, and few would characterize the future rules of engagement for EU internalization post-MiFID II as clear.



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