Fair and orderly markets – WFE Guidance

Exchanges provide the foundation for a range of crucial financial market activity

The surge in volatility earlier this year provoked some public discussion about the meaning of fair and orderly markets. When investors and issuers of securities see steep declines in the value of assets, it is understandable that they should closely monitor the effectiveness of the price-formation process. However, falling (or, rapidly rising and falling) asset prices do not imply a lack of integrity in the market on which those assets are traded.

Securities and derivatives are traded on an exchange because an exchange (unlike OTC markets) provides the foundation for pricing and re-pricing of assets and assessment of risk: access is non-discriminatory, prices are transparent and market abuse is penalised. Exchanges enforce strong disclosure standards and support high levels of investor protection.

A well-functioning exchange is one that facilitates continuous trading in securities and derivatives, and which provides for the transfer of risk and maximises the incorporation of new information in the value of financial instruments. This foundation allows market participants to make informed choices placing their orders; confident that executed trades will then be cleared and settled.

The purpose of these markets remains to serve the real economy – to raise capital for businesses, to facilitate the investment of savings, and to transfer risk to the parties willing and able to bear it.

Public health measures and the markets

The public health measures that authorities and companies have taken this year to control the pandemic have had a profound impact on all aspects of the economy. The jurisdictions under the most severe restrictions saw many businesses temporarily shuttered, and large portions of the population confined to their homes.

Market infrastructures – exchanges, central counterparties and central securities depositories – are amongst the critical elements of the financial system which must in principle remain open. For this reason, they have well-developed business continuity plans, which were executed according to plan. As in past crises, any extraordinary closure has been as strictly limited as possible. (After the 9/11 attacks in 2001, for example, the New York Stock Exchange was closed for 6 days, as IT infrastructure connecting into the market that had been damaged was repaired. It was reopened as promptly as possible, despite the febrile economic conditions.)

Under their successful business continuity plans (including remote working), market infrastructures have been operating their business robustly as usual, with record volumes of trading. In a small number of jurisdictions, the government or regulator did put in place certain restrictions on trading as a result of COVID-19, for reasons of social distancing.

Under no circumstances should restrictions on trading be invoked because a set of participants is concerned about the movement of asset prices, whatever the direction of that movement.

Volatility and orderly markets

This year has seen a diminished global economic outlook due to COVID-19, along with a series of actions by authorities that are unprecedented in modern times: restrictions on commerce and movement alongside trillions of dollars of fiscal and monetary stimulus. In such an environment, characterised by profound uncertainty and a fast-changing policy environment, volatility in the prices of financial assets is to be expected.

The effective price formation that takes place on exchanges is the result of the interaction between supply of, and demand for, securities and derivatives expressed through the pricing sentiment of a range of buyers and sellers of these financial assets—market participants with diverse trading strategies and investment time-horizons.

In periods of uncertainty and of rapid changes in information that are relevant to market participants in making investment decisions, the pricing sentiment of buyers and sellers will invariably fluctuate, which increases rather than reduces the need to keep transparent markets open. However, high volatility or significant price movements do not in themselves mean that exchange markets have become disorderly, as long as the key functions and controls of the secondary market remain operative.

During this year's volatility, some liquidity moved from opaque venues to exchanges, precisely because of the transparency, robust controls and the ability to execute against addressable liquidity in a fair and non-discriminatory manner on exchanges. Investors were able to trade in these markets with unparalleled levels of certainty that may not be present in more opaque environments where prices and liquidity are often not achievable. In this context, it is important to differentiate between an appropriate interpretation of 'fair and orderly', and a more colloquial one (which would suggest that any appearance of market turmoil implies a disorderly market).

In a recent statement warning against short-selling bans, the WFE demonstrated why it is important to allow this type of trading in volatile markets; the presence of market makers and the activity of participants with different trading perspectives and investment horizons increases liquidity in the market; facilitates price formation; and lowers the cost of investing overall. The foundation for this is that financial markets remain open and able to perform their role. The members of the WFE look forward to continuing to run these fair and orderly markets for the benefit of all.

For most detail on the topic of market integrity, refer to the WFE report**:** Market infrastructures and market integrity: A post-crisis journey and a vision for the future.

Further information about individual exchange and CCP responses to COVID-19 can be found here.