Marcelo Santos Barbosa
Chairman
Comissão de Valores Mobiliários
Rua Sete de Setembro, nº 111, 23º Andar
Centro, Rio de Janeiro - RJ, CEP 20050-901

26 June 2020

Re: SDM No. 9/19

Dear Mr Marcelo Barbosa

We welcome the opportunity to comment on SDM No. 9/19 concerning unified self-regulation in Brazil, the market structure there and the provisions around best execution in the Brazilian regulatory framework.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We seek outcomes that support market transparency, consumer confidence and economic growth. We represent over 250 market infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%).

The perspective of the WFE is informed by the 65 jurisdictions in which our members operate across the world. With extensive experience in developing and enforcing high standards of conduct, WFE members support an orderly, secure, stable, fair and transparent environment for investors and for companies that raise capital within Latin America and globally Our members support their local economies and many do so by competing for order flow from market participants foreign to their jurisdiction.

Equitable and efficient economic development through capital market reform

Capital market development has an empirically observable impact on an economy's growth.[1] Both emerging and developed markets are exploring how exchanges can enhance local capital formation, and we support these jurisdictions and market infrastructures in their efforts to bring greater amounts of capital-raising and liquidity to their markets.[2] In 2012, the US signed into law the JOBS Act, with an aim to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[3] The EU continues to seek the development and integration of this financial channel through its Capital Markets Union initiative.[4]

Brazil has also taken important strides in developing its capital markets. In our 2016 report *Enhancing Liquidity in Emerging Market Exchanges,* we welcomed Brazilian efforts to increase the participation of local institutional investors through the liberalisation of the investment mandates of pension funds, and reforms to the tax treatment of private pension and mutual funds.[5] We have likewise noted the important reforms to corporate governance that have taken place in Brazil.[6]

[1] WFE and UNCTAD, The Role of Stock Exchanges in Fostering Economic Growth and Sustainable Development, September 2017. See page 6.

[2] See: Investing in Emerging and Frontier Markets – An Investor Viewpoint, WFE and EBRD, January 2019; What attracts international investors to emerging markets?, WFE, December 2018; and, Enhancing Liquidity in Emerging Market Exchanges, WFE and Oliver Wyman, October 2016.

[3] Government Publishing Office, Public Law 112–106, April 2012.

[4] See: European Commission, Interim report of the High Level Forum on the capital markets union - A new vision for Europe's capital markets, February 2020.

[5] WFE and Oliver Wyman, Enhancing Liquidity in Emerging Market Exchanges, October 2016.

[6] WFE and Oliver Wyman, Market infrastructures and market integrity: A post-crisis journey and a vision for the future, April 2018.

The research we have undertaken in support of such capital markets development demonstrates some common principles of good policymaking, but also important distinctions in local context. In the furtherance of equitable economic growth and the efficient allocation of capital, we believe public policy should support:

- investors' access to liquid securities;
- issuers' access to capital on favourable economic terms; and,
- the integrity of the markets that facilitate the trading in these securities.

The historical patterns of financial intermediation, prevailing local regulatory frameworks, and the practices of market participants and investors are all important influences on the design of such reforms. Furthermore, policymakers may choose to pursue financial regulatory reforms that address specific policy priorities such as the development of small- and medium-sized enterprises, the prevention of financial crime and support for sustainability.[7] The relative priority of such considerations will depend on local circumstances.

Competition among market infrastructures

An appropriate sequencing of policy initiatives in the process of capital markets development supports the orderly evolution of these markets. Facilitating the introduction of competition between different market infrastructures and trading venues is a step several jurisdictions have taken in this journey. We support such competition at the appropriate level of a capital market's development in principle, while acknowledging that there are challenges and trade-offs; this applies to both trading venues and central counterparties, albeit in different ways and to different extents. It is important that the policy goals of competition are appropriate in relation to the local market and economic conditions, and that they are clearly articulated and measurable.

As described in the 2012 Oxera report prepared for the CVM, volume, liquidity and data fragmentation have the potential to occur following the introduction of competition between market infrastructures.[8] Fixed costs in certain areas risk being duplicated as a result of fragmentation, potentially leading to higher costs in the system overall. This would, for example, be the case if fragmentation were to occur while trading volume remains the same; this would result in a loss of economies of scale without any counterbalancing positive externalities. In this vein, competitors must have a sustainable business case in the short to medium term. The experience of other jurisdictions, where a loss-making alternative venue is put in place by market participants merely to artificially drive down fees at the primary, price-forming exchange ought not be repeated in Brazil. Furthermore, authorities ought to monitor the impact of a fragmented environment on illiquid securities, such as those issued by small- and medium-sized enterprises, which tend not to benefit from the introduction of trading venue competition.

New regulatory obligations to address the challenges of fragmentation have the potential to similarly add costs to the system, because it can make market monitoring more difficult for regulators. The 2012 Oxera report mentioned that the UK Financial Services Authority (FSA, as the FCA was then called) noted the challenges in maintaining market quality and integrity in the fragmented post-MiFID environment. The report states: "Although the FSA requires each trading venue to undertake real-time trade monitoring, it noted that however good an entity's monitoring of trading on its own platform, it will not have a full picture of activity of the market as a whole (in a fragmented market)." Therefore, without a careful eye to such costs in the development of the policy framework, the potential benefits from the introduction of competition could fail to materialise.

Market data fragmentation

Markets with multiple trading venues have taken a variety of approaches to addressing data fragmentation, and these approaches have been informed by the respective market structures within these jurisdictions. These frameworks have

[7] Ibid. See pages 18 and 20.

[8] Oxera, What would be the costs and benefits of changing the competitive structure of the market for trading and post-trading services in Brazil?, June 2012.

come about through considerable expense and effort, and not insubstantial controversy—and resulted in only partial success. Currently both the EU and US are considering new policy approaches.[9]

The European Securities and Markets Authorities (ESMA) has released a report on market data, and the European Commission is currently considering what legislative reforms might be included in a further consultation.[10] In responding to the original ESMA consultation on this subject, the WFE expressed its concern about the impact of the proposals on the development of European capital markets.[11] One particular challenge that we noted in this regard is the lack of genuine use-case for a consolidated tape in the EU, given the regulatory environment, market structure and prevailing business practices.[12]

As these policy debates demonstrate, solutions to the consolidation of data require a careful examination of market structures, potential use-cases, available technologies and economic costs and benefits. As such, the WFE welcomes the measured approach in SDM No. 9/19. It is in general desirable that the consolidation of data arises from commercial providers in a competitive environment in order to meet the needs of investors and market participants appropriately. Designing a framework for mandatory data consolidation would be premature given the uncertainty in how competition will develop amongst Brazilian market infrastructures and what that will entail for market structures and practices.

Liquidity fragmentation and price formation

An efficient price formation process is at the core of market integrity and a positive social externality of stock exchanges.[13] Recognising the importance of price formation, and the potential for fragmentation to negatively impact this, IOSCO has published research and issued recommendations to regulators on this topic.[14] The WFE shares this concern about the potential impact of liquidity fragmentation on price formation, recognising (as IOSCO does) that "the overall impact of competition on market quality is likely to depend on the nature of the existing market structure and the types of competition that emerge."[15]

As noted in SDM No. 9/19, a fragmented environment entails new challenges in ensuring best execution rules appropriately account for potential conflicts of interest. We agree that the introduction of an Order Protection Rule—with the attendant high fixed costs for participants and tendency to give rise to market fragmentation—would be inappropriate in the Brazilian market. Care should be given to designing a regulatory regime which neither distorts competition nor has the effect of artificially shifting trading from venues forming the reference prices for securities.

Furthermore, the regulator should closely monitor impact of competition on the quantity of price forming trades occurring in the market on an on-going basis. Additional surveillance for market manipulation will be necessary given the tendency of a fragmented trading environment to increase opportunities for abuse, while making such abuse harder to

---

[9] The US is now considering opening their consolidated tape—or securities information processor (SIP)—to competition from alternative providers. See: SEC, Proposed Rule: Market Data Infrastructure / RIN 3235-AM61, February 2020.

[10] ESMA, MiFID II/MiFIR Review Report No. 1 On the development in prices for pre- and post-trade data and on the consolidated tape for equity instruments, December 2019.

[11] WFE, Letter to ESMA on market data and consolidated tape, September 2019.

[12] See Ibid:

"[A consolidated tape has not arisen in the EU because of] the lack of a regulatory use case and poor data quality from non-exchange venues. A consolidated tape has a clearly defined utility in certain other jurisdictions, with regulatory obligations related to the underlying market structure (e.g. in the US, Reg NMS and best execution) defined in such a way, that the data contained in the tape has a role in meeting users' compliance obligation. In contrast, in the EU best execution rules, for example, take in factors beyond price--just one of many differences…Commercial incentives are furthermore in place for US exchanges to provide their data to the consolidator."

[13] Janet Austin, What Exactly is Market Integrity? An Analysis of one of the Core Objectives of Securities Regulation, February 2017

[14] See: IOSCO, Regulatory Issues Raised by Changes in Market Structure, December 2013. They characterise a fragmented trading environment as one where "the location of buying and selling interest for individual securities is fragmented to the extent that quotations and orders in different trading venues may not have an opportunity to interact."[14]

[15] IOSCO, Transparency and Market Fragmentation, November 2001.

detect. Brokers should be subject to a clear definition of best execution, with pre-defined criteria, to allow the end investor to efficiently compare execution quality.

Recent years have seen shifts in market microstructures and business practices in many jurisdictions, driven by changes in trading technology, investment strategy and the proliferation of trading venues.[16] Closing auctions have taken on increasing importance with an increasing proportion of investment mandates passively managed and investors are responding to these trends and changes in market structure with new techniques for avoiding market impact.

The introduction of competition adds to the complexity of interactions between trade execution techniques. For example, the introduction of competition in MiFID led to an unintended shift from lit to unlit venues—a development which policymakers attempted to remedy in MiFID II/MiFIR, and which continues to be of concern in the EU.[17]

It is important to mention here that the fragmentation caused by this unintended shift from lit to unlit venues may occur not only because of the introduction of new infrastructures in the market, but also in line with the way the trades can be executed, i.e. if some new environments are permitted to offer different modalities of trading, as proposed in SDM No. 9/19. The possibility of block trades being executed in off-exchange environments, without central counterparty clearing, is of particular concern.

We understand the popularity of venues dedicated to blocks in several regions. Given the growth in the domestic Brazilian buy-side, and the growing presence of global investors in the market, there may be similar demand in Brazil. It is important that block trades linked to dark pools or order internalisations not have a negative impact on the quality of the lit market, e.g. by harming order book price formation.

Given these challenges and complexity, we believe it may be advisable for Brazilian authorities to adopt a conservative approach in introducing block trading to the Brazilian market. This modality of trading ought to be carefully assessed, and conducted solely in a regulated trading venue, with rules ensuring equal access and investor protection. Furthermore, we believe these trades ought to be centrally cleared -- a means of promoting market integrity endorsed by leading global regulators. Likewise, the CVM may wish to retain its powers in setting parameters regarding block order sizes as the system beds in.

Conclusion

We support the CVM in pursuing reforms that foster equitable and efficient economic development. The clear alignment of policies with policy objectives, the use of rigorous cost-benefit analysis, the adoption of the principle of proportionality and the development of well-paced implementation timetables (with space for post-implementation analysis) will support positive outcomes. We believe the policy goal of competition ought to be cost reduction for the end investor—not merely a cost reduction for intermediaries, and opacity for end investors, as has been observed in other markets following the introduction of competition. Competition should not allow for regulatory arbitrage, and the impact of competition on market liquidity and price formation ought to be carefully assessed.

Given the health crisis and economic dislocation as a result of COVID-19, it is likely that the CVM, like other global regulators, will wish to review its priorities for policy reform. We support such prioritisation and recognise the overriding importance of financial stability and economic stabilisation in the current context.

We stand ready to discuss the issues contained in this paper or any others of interest to the CVM, should that be helpful.

Best regards,

Nandini Sukumar

[16] WFE and Oliver Wyman, Market infrastructures and market integrity: A post-crisis journey and a vision for the future, April 2018.
[17] Monica Petrescu and Michael Wedow, Dark pools in European equity markets: emergence, competition and implications, July 2017.