

1 November 2024

VIA Electronic Mail

Economic Analysis, Risk Management and Integrity Office
Comissão de Valores Mobiliários
asa@cvm.gov.br

Re: Public Call for Contributions ASA/CVM No. 01/24."

To whom it may concern:

The World Federation of Exchanges (WFE) welcomes the opportunity to submit a contribution to the Comissão de Valores Mobiliários (CVM) on its recent public Call for Contributions regarding the internalization of orders. The WFE applauds the CVM for its ongoing efforts to ensure the efficiency and competitiveness of the Brazilian capital markets. The WFE respectfully offers its thoughts only on question #1 of B.1, question #2 of B.2, question #3 of B.3, question #4 of B.4, and to B.7. of the public Call for Contributions. Our response is intended to complement any representations from our members.

Thank you for your consideration in this matter.

Yours sincerely,



Nandini Sukumar
Chief Executive Officer
The World Federation of Exchanges Ltd

Background

Established in 1961, the WFE is the global industry association for exchanges and clearing houses. Headquartered in London, it represents the providers of over 250 pieces of market infrastructure, including standalone CCPs that are not part of exchange groups. Of our members, 36% are in Asia-Pacific, 43% in EMEA and 21% in the Americas. The WFE's 87 member CCPs and clearing services collectively ensure that risk takers post some \$1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. The exchanges covered by WFE data are home to over 55,000 listed companies, and the market capitalization of these entities is over \$111tr; around \$124tr in trading annually passes through WFE members (at end-2023).

The WFE is the definitive source for exchange-traded statistics and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable, and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally 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:

Frank Hatheway, Senior Advisor, Market Structure: [REDACTED]

Richard Metcalfe, Head of Regulatory Affairs: [REDACTED]

Nandini Sukumar, Chief Executive Officer: [REDACTED]

Response

Introduction

The World Federation of Exchanges (WFE) welcomes the opportunity to respond to the Public Call for Contributions ASA/CVM No. 01/24 issued on May 9, 2024, by the Comissão de Valores Mobiliários (CVM) and the Economic Analysis, Risk Management and Integrity Office. The WFE and its members appreciate the CVM's work to enhance investor and consumer confidence in the Brazilian Capital Market and the careful and detailed work of the Economic Analysis, Risk Management and Integrity Office in preparing the Partial Regulatory Impact Analysis Report (Partial AIR). All the WFE's comments in this response are focused on questions #1 in B.1, #2 in B.2, #3 in B.3, #4 (but not #4.a) in B.4 and B.7 in the Call for Contributions. The other questions raised in the Call for Contributions are not addressed by the WFE.

General Comments in response to B.7.

As noted in the Partial AIR report, the definition of internalization to be addressed is “**...the interposition, by a securities intermediary, of a trade that otherwise could have found different counterparties in the competition and pricing process.**” The WFE has no objection to this general definition but does note that in some jurisdictions this definition would include both large in size (block) transactions and smaller transactions, both retail and institutional, among other distinctions. The majority of the WFE's comments are on off-exchange retail internalization although applicable to other types of internalization as well. A number of WFE members currently offer internalization, as defined by the Partial AIR, subject to the vigorous oversight of their national competent authorities. The customers of WFE members may also offer internalization of executions if permitted by their jurisdiction's rules and regulations.

As seen in Section II of the Partial AIR report, the rules and regulations regarding internalization vary considerably across jurisdictions. It should be noted, however, that these rules and regulations should have a common goal, the goal of ensuring that a jurisdiction's capital markets meet the needs of investors both large and small.

Public markets operated by regulated exchanges are the regulatory gold standard within a financial ecosystem. A healthy financial ecosystem plays a significant role in helping a society to prosper. Well-regulated public markets within that system reinforce investors' trust in the financial system. The WFE considers Transparency, Liquidity, Non-Discriminatory Treatment, Neutrality, and Regulation to be necessary for a public market to be a regulatory gold standard.¹

In the jurisdictions where internalization is allowed, internalization plays a different role to the public markets. Trust is built on a neutral and secure market with healthy price formation as a reference for a fair price of each asset and that includes equitably all types of investors. Policy makers and regulators risk jeopardising both markets if investors' trust erodes. In recognition of the importance of maintaining investors' trust the WFE recommends that the principles of transparency, non-discrimination, and neutrality should be uniformly enforced in order to maintain a trustworthy

¹ In the context of this paper the WFE defines transparency as the transmission of transaction and quotation information to potential investors thereby providing investors with the information necessary for evaluating the current expected price for the security. Non-discrimination is the principle of fair and equivalent access to the market and the principle of isonomy, equality in treatment before the law, in regulation. Non-discriminatory treatment allows public secondary markets to be viewed as neutral and trusted parties by investors. Neutrality refers to impartiality by the market operator with respect to the value of issued securities. Although dealers and other non-neutral market professionals co-exist with investors in public secondary markets, the WFE considers that neutrality by the market operator itself is critical for creating trust in public secondary markets.

and healthy environment. The rationale for the WFE recommendations is developed more fully in the specific responses that follow.

Overall, the WFE urges the CVM to carefully consider all the implications of expanding internalization in the Brazilian financial markets.

Specific Comments on Questions #1, #2, #3, and #4,

The WFE believes it is well suited to respond to four specific questions raised in the Public Call for Contributions. With regard to questions 1 and 2 of Sections B.1 and B.2, the WFE notes that the definition of the problem to be solved often determines the answer. The WFE therefore offers its thoughts on how the regulatory problem facing CVM is defined and analysed. With regard to question 3 in Section B.3 the WFE believes that current submitters of limit orders to the B3 order book would be adversely affected by internalization and the impacts on such submitters have been insufficiently addressed in Section IV of the Partial AIR. With regard to question 4 in Section B.4 the WFE believes that the role of the irreversibility of a decision to allow off-exchange retail internalization, regulatory precedent and geographical proximity could be more developed in Section V of the Partial AIR. The WFE's responses in detail are as follows.

Jointly addressing question 1 of B.1 and question 2 of B.2, based on the Executive Summary the WFE believes that the overarching problem to be solved is that of whether to allow the off-exchange internalization of retail orders with three regulatory problems influencing the discussion: (i) adverse selection; (ii) public goods; and (iii) transaction costs.

There are distinct profiles among participants in secondary markets to explore before addressing the first regulatory problem of adverse selection. In the academic literature, there are informed traders, uninformed or "noise" traders, and liquidity providers.^{2,3} A "retail investor" is often assumed to be uninformed, an "institutional investor" is often assumed to be informed, and a "liquidity provider" is often assumed to be a risk-averse market maker. The Partial AIR makes assumptions that are in line with the commonly made assumptions, but such assumptions are just that and counter examples exist to all three.⁴ Therefore the assumptions in the Partial AIR may not be fully applicable should off-exchange internalization of retail orders be allowed.

In addressing the first regulatory problem raised in the Executive Summary and analysed in detail in Sections II and III, the WFE respectfully points out that retail order flow can be informed and also can have price impact. Retail order flow can become one directional, the "GameStop" phenomenon in the United States being an extreme example. While individual retail orders may be uninformed and contain little to no adverse selection risk, collectively the presence or

² One early reference is L. Glosten and P. Milgrom, "Bid, ask and transaction prices in a specialist market with heterogeneously informed traders", *Journal of Financial Economics*, 1985. It should be noted that the orders off all three types are typically not observed in data and must be inferred.

³ In the early literature such as Glosten and Milgrom, an informed trader only traded when they received private information about an asset's value. The uninformed trader entered the market for liquidity purposes. In the more recent literature and in this paper, an informed trader has superior knowledge of the probability distribution of share prices, through either access to private information or skillful processing of public information. An uninformed trader does not have the same information. For a non-technical treatment of the recent definition see K. Strauss, "When and Where are Informed Traders...", *CFA Institute Journal Review*, 1 June 2017. The original source for the recent definition of an informed trader can be found in Easley, O'Hara, and Paperman, "Liquidity, Information, and Infrequently Traded Stocks", *Journal of Finance*, 1996

⁴ For institutional investors see for example X. Yan and Z Zhang, "Institutional Investors and Equity Returns: Are Short-term Institutions Better Informed?" *Review of Financial Studies*, 2007. For retail investors see for example K. J. Gamble and W. Xu, "Informed Retail Investors: Evidence from retail short sales", *Journal of Empirical Finance*, 2017

absence of information in retail order flow may be valuable for anticipating future prices.⁵ The possession of information from retail order flow gives rise to adverse selection risk that is not considered in the Partial AIR.

Whether and how information obtained from off-exchange retail internalization of orders is transmitted to the market is a significant issue for investors and for the Regulator. The possibility of an informed order from the operator of a retail internalizing market creates negative impacts on the overall market.

The Partial AIR describes how informed trading may increase adverse selection costs and decreases the provision of lit liquidity which is a public good.⁶ The Partial AIR also discusses some explicit and implicit transactions costs but does not discuss the impact on the true transaction costs of retail trades from the failure of an off-exchange retail internalizing market operator to appropriately compensate individual retail orders for their contribution to retail orders' collective value.⁷ The Regulator is left to be responsible for the mitigation of any negative impacts that may arise from off-exchange retail internalization.

The minimization of the negative impacts of informed trading created by the off-exchange internalization of retail orders drives the WFE's recommendations. Information is crucial in determining the fair value of an asset and understanding market trends. Therefore, WFE emphasizes that pre- and post-trade transparency requirements should be taken seriously to maintain market integrity. Non-discriminatory access to an off-exchange retail internalizing market by all retail investors prevents the market operator from refusing access to retail investors who wish to act upon information gleaned from retail order flow, particularly in situations when retail order flow shows little to no price impact. Neutrality on the part of the market operator is essential to ensure that financial markets operate efficiently, fairly, and transparently, promoting investor confidence, preserving good price formation and the stability of the financial system.

Turning to question 3 from B.3 on Section IV of the Partial AIR, the WFE notes that the focus of the Partial AIR is on the experience of marketable orders in its review of the literature on the USA, EU, Canada, and Australia. Non-

⁵ Chakrabarty, Bidisha and Cox, Justin and Upson, James, The Information Content of Retail Order Flow: Evidence from Fragmented Markets. Available at SSRN: <https://ssrn.com/abstract=4466223> or <http://dx.doi.org/10.2139/ssrn.4466223>, García-Méndez, David, "Does Retail Order Flow Internalization Increase Information Acquisition?" (November 11, 2023). Available at SSRN: <https://ssrn.com/abstract=4629902> or <http://dx.doi.org/10.2139/ssrn.4629902>. Hoffmann, Peter and Jank, Stephan, "What is the Value of Retail Order Flow?" (July 01, 2024). Available at SSRN: <https://ssrn.com/abstract=4931257> or <http://dx.doi.org/10.2139/ssrn.4931257>. Kelley, Eric K. and Tetlock, Paul C., How Wise Are Crowds? Insights from Retail Orders and Stock Returns (January 2012). Journal of Finance, Forthcoming, Available at SSRN: <https://ssrn.com/abstract=1668706> or <http://dx.doi.org/10.2139/ssrn.1668706>

⁶ The analysis of the Public Goods problem correctly focuses on the questions of pricing market data and the posting of quotations, either from displayed limit orders or dealer quotations, in the displayed market. Measuring changes in the amount of displayed liquidity is one approach but does not capture changes in the "quality" of the displayed liquidity that may occur with off-exchange retail internationalization due to the endogeneity of order submission strategies. Extant academic studies such as Hans Degryse, Frank de Jong, Vincent van Kervel, "The Impact of Dark Trading and Visible Fragmentation on Market Quality" Review of Finance, 2015 indicates that displayed liquidity decreases with the availability of dark trading. As stated in our general comments, off-exchange retail Internalisers should be required to publicly display their quotations, the prices at which investors can expect to buy and sell securities, in order to mitigate the Public Goods problem

⁷ Explicit Costs include Broker commissions, Exchange fees, Regulatory fees, Stamp duties (depending on region) and Margin interest (if borrowing to trade) not all of which are addressed in the Partial AIR. Implicit Costs include Market impact cost (price movement caused by a large trade), Slippage (difference between the expected price and the price at which the order is filled), Opportunity cost of capital (potential return lost by investing in a stock instead of another option), Time delay costs (missed trading opportunities due to slow order execution) and Bid-ask spread (the difference between the buy and sell price of a stock). Again, not all implicit costs are addressed by the Partial AIR.

marketable limit orders are only mentioned in the review of the Foley and Putniņš paper on Australia and Canada.⁸ Section IV's focus on the market quality impact of marketable orders, either market or marketable limit, reflects the majority of the literature for the simple reason that such orders are relatively easy to identify since they result in a trade. The impact on the other side of the trade, the limit order, should also be considered when evaluating internalization. There are at least two aspects of internalization's impact on limit orders to consider. The first is the endogeneity of the choice of order type, limit or marketable. The second, related, impact is the isolation of limit orders when marketable orders are executed elsewhere. A review of the literature on limit orders can be found in Dahlström, Hagströmmer, and Nordén (2024).⁹

In response to question 4 from B.4, the regulatory discussion In Section V of the Partial AIR does not address that the decision to allow or expand off-exchange retail internalization is a one-way decision. Once off-exchange retail internalization is allowed or expanded it is very difficult, if not impossible, politically to reverse the decision. The USA and many of the EU member states have had security trading for centuries and have long allowed for internalization. Australia, although it seems an apt comparator, shares the traditions of the UK with the USA and Canada. Furthermore, Canada enjoys a special relationship with the USA in terms of the securities laws and many of the most active Canadian stocks trade extensively in the USA where internalization is widespread. Any experience of jurisdictions that have successfully decided to disallow previously approved off-exchange retail internalization should be discussed. We specifically suggest exploring the changes in UK market structure in response to MiFID 1, MiFID 2 and post-Brexit. If no jurisdiction which has successfully decided to disallow previously approved off-exchange retail internalization can be found, however, then the reasons for that finding should also be discussed.

Concluding Thoughts

In closing, the WFE wishes to restate its appreciation for the opportunity to express its views on the Public Call for Contributions ASA/CVM No. 01/24. The CVM is to be applauded for the thorough and public approach it is taking to off-exchange retail internalization in the Brazilian financial markets. The CVM is also to be applauded for its ongoing efforts to ensure the efficiency and competitiveness of the Brazilian capital markets.

To summarize our primary recommendation, the WFE recommends that entities engaged in equivalent activities should have equivalent regulations. Specifically for jurisdictions where internalization is allowed the WFE recommends regulations regarding transparency, non-discrimination, and neutrality should be the same for entities offering internalization as for other entities offering trading services. We also have included more specific comments on other aspects of the Partial AIR. Overall, the WFE urges the CVM to carefully consider all the implications of allowing off-exchange retail internalization in the Brazilian financial markets.

We look forward to engaging on these issues further with CVM and would be happy to address any questions or comments you may have.

⁸ Sean Foley and Tālis J. Putniņš, "Regulatory efforts to reduce dark trading in Canada and Australia: How have they worked?", CFA Institute, 2014

⁹ Petter Dahlström, Björn Hagströmmer, and Lars Nordén, "The determinants of limit order cancellations", The Financial Review, 2024