

Comissão de Valores Mobiliários
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Subject Response to the RIA on internalisation of orders

Dear all,

Optiver is grateful for the opportunity to provide input to the CVM on its regulatory impact analysis regarding internalisation of retail orders in the Brazilian market. As background, Optiver has a longstanding presence in Brazil since 2010 and consistently ranks amongst the most active liquidity providers in stock options and futures as well as in index options on the B3 exchange. We are also an active participants across many of the world's major financial jurisdictions, including the United States and the European Union. It is with these experiences that we would like to contribute to the discussion on internalisation of retail orders in Brazil.

The main point we would like to raise with the CVM is that we believe that internalisation of retail orders within an exchange environment can be useful in products that are highly liquid and competitive, such as the mini Dollar and mini Ibov future. In these cases segmentation (subject to a limit) of some retail flow would not materially affect market quality and can deliver good execution outcomes for retail investors. We would however strongly caution against permitting internalisation of orders in less liquid products. Drawing volume away from the orderbook would undermine price formation and price efficiency in these products. In a similar vein we would caution against permitting internalisation of order flow in alternative venue structures. The lower levels of transparency (also post-trade) associated with such mechanisms would only further undermine price formation in the central limit orderbook and deteriorate market quality and attractiveness overall. We therefore ask that the CVM refrain from extending the ability to internalise retail orders beyond the current scope.

On a more general level, we would emphasise the importance of maintaining a market structure in which the vast majority of order flow can be competed for by any market participant. This will ultimately deliver the most optimal outcome for end-investors whilst at the same time delivering the secondary benefit of having a more liquid and efficient market overall.

To illustrate our argument in more depth, we would like to focus on two areas that we believe should be factored in by the CVM in its decision-making regarding internalisation. Namely the following:

- What are the characteristics of a competitive market? How does this benefit end-investors and market participants? What features drive the overall attractiveness of the market?
- Is it appropriate to draw conclusions from the experience of other financial jurisdictions with order internalisation?

Competitive markets

Competitive markets tend to be characterised by a high degree of competition between liquidity providers. This drives better pricing outcomes in an exchange trading environment by giving market participants the ability to trade at bid/ask spreads that are as tight as possible. More efficient markets in terms of pricing also tend to result in higher overall trading volumes as well as more volume being available in the top layers of the order book for the traded instruments.

If the ability to segment a subset of the order flow is introduced in such an environment that is characterised by highly liquid financial instruments with minimal bid/ask spreads – e.g. one tick or tick constrained – it can deliver better outcomes for retail investors if their execution costs are lower than if the order had been sent directly to the orderbook.

However, were segmentation and internalisation of retail orders to be permitted in less liquid products – e.g. where spreads tend to be wider than one tick – it is very likely to result in retail orders getting worse execution than if the order would have been sent to the orderbook and competed for by a large range of liquidity providers. For example, were internalisation to be allowed in a product where spreads are regularly 5 ticks wide, then internalised retail orders would see a 1 tick improvement at best (as per current RLP rules). Whereas if they were submitted to the order book, chances are significantly higher that over time order books would tighten beyond the 1 tick improvement as function of price competition in more diverse order books with less adverse selection.

From our perspective, the absence of competition through segmentation – where price improvement would be possible – almost inevitably results in worse outcomes for retail investors. It also tends to deteriorate the quality of the main market if the possibility of only (or largely) encountering informed order flow is significantly higher. A higher likelihood of adverse selection will drive the way liquidity providers are willing/able to support efficient pricing in the market. This will in turn undermine liquidity in the market, have a negative impact on price formation, and render the market in these products less attractive to investors. What we tend to observe in other jurisdictions is that if the conditions are created for having highly liquid products, it tends to draw in more trading interest. This in turn does not only drive liquidity, but also allows for a much more efficient risk transfer capacity as ever larger volumes can be executed in the top order book layers.

International comparison

Whilst we think it makes sense to investigate what structure for internalisation other jurisdictions have put in place, we would wish to highlight that it is important to factor in the specifics of each jurisdiction's market structure and market composition, which can and should stand in the way of drawing too many parallels.

For instance, there is a large degree of internalisation of retail orders in the US market. It is important to point out that because of the way retail orders are handled, they do generally receive price improvement. However, it is not necessarily the best price improvement that would have been possible had they not been internalised or traded through a price improvement mechanism on exchange that still gives the routing market maker a guaranteed allocation. Moreover, the incentives structures that have been put in place around the handling of retail orders in the US do not contribute to an open and competitive environment for the execution of retail orders. And the majority of order flow is held captive by a small number of market participants¹. Given the

¹ In-depth series of papers that explains the market structure for the handling of retail orders in the United States: <https://optiver.com/insights/directed-market-makers-another-path-to-internalization/>

modalities of how this works in practice in the US, there are serious questions that can be raised as to whether retail investors actually receive the best possible outcome for their orders.

On the European side, a significant proportion of retail orders are routed through non-competitive mechanism^{2,3}. In the German market the majority of retail flow does not pass through the main exchange (Xetra/Deutsche Boerse) but is sent to a number of regional stock exchanges that operate exclusionary liquidity provision models that only permit a single liquidity provider to be in the market. Brokers are then incentivised to route their order flow to these venues with monetary incentives (PFOF) as well as reduced post-trade workflows that remove settlement costs. This allows them to offer their customers zero or low commission trading. The end result is that retail orders are executed on these regional markets with the single liquidity provider taking the other side of most trades. Moreover, in the absence of competition from other liquidity providers, the retail order receive minimal price improvement and receive worse execution than they would have received on the main reference market for the traded instrument. Concurrently the overall market is characterised by a relatively low level of retail participation as well as a fragmentation of liquidity along product and venue lines. As a result, it is generally considered that European markets have become increasingly less competitive and are characterised by lower volumes than their international peers.

Bringing this back to the Brazilian trading environment, if the desire is to have an attractive, highly liquid market that is characterised by a diversity of market participants that are in competition with one another, then internalisation should be approached with caution. It is also important to note that the Brazilian market has quite unique characteristics – especially in terms of strong retail participation. Therefore, we think that the CVM should create a market structure that supports and enhances these unique attributes rather than seeking to mirror market structures found in other jurisdictions with their own unique attributes. With this in mind, it can make sense to permit a degree of internalisation in products like the mini Dollar and mini Ibov future which are very liquid. This must still be in conjunction with tightly formulated price improvement requirements and caps on the maximum volume that can be internalised. It would however, unlikely deliver better outcomes for retail investors to permit internalisation in less liquid products like options or in off exchange environments. Fragmentation of liquidity would only undermine the quality of the reference market. At the same time, retail investors would only see minimal rather than optimal price improvement. Also overall order book quality would suffer as market participants will become less inclined to show (significant) volume without charging a sufficient risk premium.

So in sum, we would emphasise the importance of maintaining a market structure in which the vast majority of order flow can be competed for by any market participant. This will ultimately deliver the most optimal outcome for end-investors whilst at the same time delivering the secondary benefit of having a more liquid and efficient market overall.

We therefore ask that the CVM refrain from extending the ability to internalise retail orders beyond the current scope.

Should you have any questions, we stand ready to provide additional clarifications or context to the points raised in this submission.

² Explanation of how segmentation of retail orders works in Germany: <https://optiver.com/insights/not-just-pfof-another-anti-competitive-threat-to-european-markets/>

³ AFM (Dutch Authority for the Financial Markets) study on quality of execution on PFOF venues: https://www.afm.nl/~profmedia/files/doelgroepen/beleggingsondernemingen/2022/afm-paper-assessment-execution-quality-pfof-venues.pdf?sc_lang=en&hash=7391A258C7DA038BEE6B4A17247C465D