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Stories

Game plan

Simultaneous listing project by ATS calls for regulatory changes and raises questions about price formation

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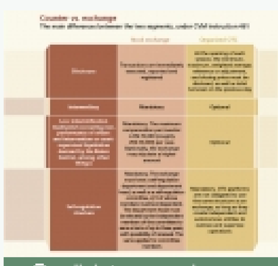

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Americas Trading System Brazil wants to end the BM&FBovespa's monopoly in the country. The new player, which goes by the acronym ATS, is a joint venture between NYSE Euronext and Americas Trading Group (ATG), a Brazilian company. If all goes according to plan, ATS will file an official request with the Securities and Exchange Commission of Brazil (CVM) in March, asking permission to operate a stock trading platform in the country. Direct Edge, an American company, has also entered talks with the Brazilian regulator and is planning to apply for permission to launch a new securities exchange in the near future. This is not the first time that international agents have explicitly shown interest in operating a stock trading platform in the country. And each new round of promises sheds new light on the daunting path ahead for new players entering the field, long monopolized by the São Paulo exchange.

In essence, the biggest stumbling block for ATSare the regulations currently in effect. The company is planning to launch a stock trading platform by 2014, organized in an over-the-counter format (*see box for more information*). Instead of listing new companies, its business model will provide a second trading environment for companies that are already listed on the BM&FBovespa. The problem is that article 57 of Instruction 461, created in 2007 to organize the operations of regulated securities markets, forbids the simultaneous listing of shares in exchange and OTC environments.

The main difference between the two is the level of price and transaction disclosure. In an organized OTC market, immediate disclosure of transactions is not mandatory. This type of market can wait until trading begins before disclosing its price references for the previous day, giving investors a chance to trade without immediately interfering in prices. On an exchange, a transaction's disclosure and impact on price is immediate. An additional difference is that OTC markets are allowed to operate without intermediaries, under Instruction 461 — although Cetip, an organized OTC market focusing on fixed income securities, has chosen to require intermediation, as ATS is also planning to do.

The ban on simultaneous listing guaranteed a market reserve for local exchanges during the demutualization of the São Paulo exchange. It was the chosen solution for preserving the industry's modus operandi, as both the BM&F and Bovespa (which would later merge, creating the BM&FBovespa) were already expected to go public at the time. Modifying the regulatory environment too drastically would potentially have pushed down the IPO price achieved by each exchange. Overseas, investors were already concerned about the market share loss suffered by exchanges like NYSE due to the advance of OTC environments, such as the so-called dark pools used for large trades. The simultaneous listing ban also permitted the exchange demutualization process to move forward without having to deal with some regulatory gaps, at least not immediately. In 2007, there was no rule obligating intermediaries to execute orders placed by an investor for the best price available on the market — an essential condition for systems in which a same asset can be available for trading on more than one environment. The gap was only closed years later, in 2011, when the CVM issued Instruction 505 on rules and procedures to be observed in securities transactions.

The rule made it mandatory for intermediaries to execute orders according to client specifications or, if none are made, "under the best conditions permissible by the market", taking into account factors beyond price — including cost, speed, volume, and probability of execution and settlement. An additional responsibility imposed on intermediaries by Instruction 505 is making sure that clients are informed about the different markets where a security can be traded. The measure clearly shows that over the years, Brazilian regulation has started preparing for a competitive environment.

ATS acknowledges the barrier against simultaneous listing, but does not consider it a setback. ATS president Alan Gandelman confirms the company's intent to file a formal request with the CVM to obtain permission for trading, even with the rule still in place. The idea is to work together with the regulator and promote the necessary adjustments to make the project feasible, while the request is under analysis. Sources contacted by CAPITAL ABERTO confirmed that the CVM sees no reason to maintain its veto on double listing. On the contrary, the regulator has always known that adjustments to Instruction 461 would eventually be needed.

> The ban on simultaneous trading assured a market reserve for local exchanges during the demutualization

PRICE BREAKDOWN — A fragmented stock trading market creates structural problems that are being discussed in several countries. The question is how to guarantee price formation efficiency when a security is listed on more than one environment, under different rules.

At present, 100% of all stock trades in Brazil are transacted through the BM&FBovespa. This means that the exchange environment — and therefore the prices practiced therein — represents 100% of all intended transactions for a given share. With the arrival of one or more competitors, the demand will spread out. For perspective, in the United States, thirteen stock exchanges and about 50 OTC markets are currently in operation, which means a highly dispersed demand for any given asset transacted on multiple environments. The criticism for this scenario is based on the fact that prices are usually only referenced on the biggest trading platforms. This means that trading prices may not accurately represent all the trading intentions for an asset.

The discussion around price formation efficiency in a fragmented market is going at full steam outside Brazil. Last December, a subcommittee of the U.S. Senate heard representatives from the country's leading trade platforms. NYSE Euronext and NasdaqOMX defended that the regulatory differences between exchanges and OTC are harmful to the market because they promote significant migration of trading into less transparent environments.

The differences in the rules that apply to a stock exchange and to an OTC market in the U.S. are more significant that what we should expect to see in Brazil. A dark pool, for instance, can fill large buy or sell orders outside of the exchange environment, preserving the anonymity of the parties involved until the transactions are complete. In Brazil, this model could not be emulated because article 22 of Instruction 505 forbids trader anonymity. Nevertheless, a modern and sophisticated OTC environment is likely to attract investors interested in buying and selling large chunks of stock without causing an impact on share price.

> No one knows how the prices formed in each environment will be conjoined in Brazil

No one knows how the prices formed in each environment will be conjoined in Brazil. The impasse applies both to the plans announced by ATS, which intends to create an organized over-the-counter market, and to Direct Edge, which is planning to set up an exchange. Multiple listing was permitted in Brazil when regional exchanges used to trade the same shares, regardless of the state where they were originally listed. They conversed by holding auctions. If an order was transacted for a much different price than what the main market was listing, all trading was suspended so that an auction could be held.

Back then, this type of interference was already considered outdated. "Today, the arrival of a competitor would require creating an information system," says Gilberto Biojone, consultant and member of the International Stock Exchange Executive Emeriti (Iseee). This pricing "central" would be something similar to the National Market System (NMS), which monitors the different markets in the U.S. and discloses the best buying and selling prices for a security.

Self-regulation is an additional aspect to be addressed in a scenario with more than one stock trading platform in operation in Brazil. Instruction 461 requires every organized market, whether exchange or OTC, to maintain a self-regulation structure responsible for identifying possible regulation breaches, abnormal trading conditions, or behaviors that jeopardize the market's credibility. So ATS and Direct Edge would have to create independent setups to supervise the market, or hire a service provider to assume that role. Fragmentation is likely to make the CVM's work more complex and costly, as the regulator will have to keep an eye on all these agents and all the different regulations created by each one. It's no coincidence that British consultancy Oxera, in a study commissioned by the CVM and released in June 2012, estimated a total extra cost of US$ 10 million in annual regulation expenses.

A counter, for starters

Of all the prospective new competitors for the BM&FBovespa, Americas Trading System Brazil (ATS) is the first to affirm that it will not be initially organized as a stock exchange. ATSwas designed to start out as an organized OTC market focusing exclusively on stocks of already listed companies. Later, it may expand into a full-fledged exchange. ATS also got a head start by announcing its head executive in Brazil: Alan Gandelman, who served as CEO of broker Icap for five years. The company also surrounded itself with heavyweight advisors, including law firms Motta, Fernandes Rocha and BM&A.

The strong suit of the ATS project, according to Gandelman, is its DNA. NYSE Euronext, a minority partner in ATS, will be the calling card for foreign organizations that do not yet invest in Brazil. At the other end will be ATG, a Brazilian company created two years ago by former executives of ÁgoraCorretora, specializing in electronic trading and order routing. "ATG already handles a heavy flow of transactions, but that flow is currently directed to the BM&FBovespa. Transforming into an exchange is a natural path for us," says Gandelman, who promises to offer a technology that is not yet available on the Brazilian market.

The executive believes that two things will give ATS a competitive edge: its ability to attract new investors using NYSE technology, which will offer faster order execution; and the benefits of handling large trades in an over-the-counter environment. "The rise in trading volumes would also benefit the BM&FBovespa," Gandelman emphasizes, arguing that the business attracted by ATS would also spill over onto the exchange. "We intend to achieve 15% market share in 2014," he affirms.

The need for a clearinghouse, one of the biggest sticking points for competing with the BM&FBovespa, would not be a problem for ATS. Gandelman believes that the exchange would not refuse to share its clearinghouse, given that it would get a double opportunity for gain: as a service provider and as a beneficiary of the higher liquidity brought by the new platform. But what if no deal can be worked out? Gandelman does not reveal his "plan B", but admits that one exists.

Direct Edge wants to set up a traditional stock exchange. According to its strategy officer, Anthony Barchetto, the competition brought by the company is likely to make the Brazilian market more competitive, less costly, and more investor-friendly. Direct Edge will focus on implementing its expertise in high-performance technological innovation. "We will adapt our business model to Brazil," he says. (Yuki Yokoi and André Rossi)

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