Of figures and fairness

Michael Krogmann* provides a holistic insight into defining market quality.

It feels like ages ago when the comparison of explicit trading cost combined with the liquidity in a specific instrument seemed enough for market participants to make an educated choice on which market to trade. This was before the credit crunch in 2008. Investors lost a lot of faith then, and in the face of an increasingly fragmented European equities trading landscape it should surprise no-one that this faith has not been fully restored yet.

Consequently, market participants have been looking for better means to identify the very trading venue which supports their individual strategy best. Over the last few years, their focus has been shifted from cross-venue comparisons regarding market share and liquidity to a much bigger picture: the overall quality, accessibility and the level of pre-trade transparency a market has to offer.

Quantifiable indicators

There is an industry-wide consent that market quality can be determined – and compared – by measuring spreads at touch, best prices at touch, and the quoted order book depth of a market, per instrument or index. A very popular example for this is the "battlemap of the exchanges", a comparison of these indicators plus the respective market share regarding Europe's major trading venues, and including eleven European indices. This decision-making tool, provided by LiquidMetrix, a neutral and independent research provider, has proven so useful for market participants that Deutsche Börse decided to provide the relevant data on xetra.com for comparing market quality for trading of the German benchmark index DAX. However, these indicators work best with big trading venues attracting all kinds of investors, providing a heterogeneous and pan-European order flow. The more specialized a trading venue is, the less weight these figures have, and the less they qualify for comparison.

The need for diversity

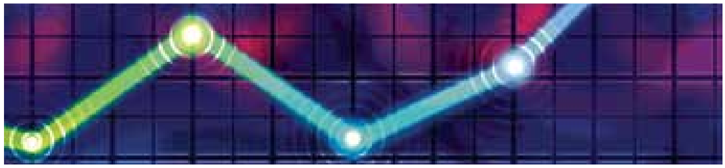
The kind of liquidity a market participant needs to pursue his investment objectives depends on his trading strategy. And just like trading strategies, liquidity pools can vary widely – making it considerably more difficult to compare trading venues. A marketplace attracting mainly high frequency traders might provide high liquidity which could be of lesser benefit for other kinds of investors. Thus, a liquidity pool reflecting a multitude of traders' interests will cater to the needs of a broad variety of investors.

Another important factor regarding the diversity in counterparties is their direct influence on a market's ability to recover from the impact of an order. The more diverse the liquidity in a specific instrument is, the more resiliency a market participant can expect.

Fairness: a fundamental factor

Part of the academic literature differentiates between market quality and market integrity, maybe because integrity cannot be quantified as neatly as transaction cost or liquidity. In fact, integrity is a vital part of the overall market quality – and, of course, part of transaction cost, if not an obvious part. Michael J. Aitken, CEO and chief scientist at the Capital Markets Cooperative Research Centre (CMCRC), has contributed greatly to the discussion on market quality and its usefulness as a decision-making criterion for investors. In his eyes, a high level of market quality can only be obtained in a fair and efficient market. Consequently, his definition of market quality includes market integrity as one of three main components, the other two being market efficiency and systemic risk. Therefore, Aitken and his colleagues searched for means to quantify certain types of market integrity-threatening behaviour in order to make the level of integrity as comparable as, for example, best prices at touch. They developed proxy alerts to measure some of the most common forms of market abuse, such as front running, trading ahead of price sensitive announcements, and ramping at the close. Aside from these measures to assess market abuse, the level of market supervisory presence at a specific trading venue is always a reliable indicator for fairness in a market. In this aspect, regulated exchanges offer the fairest trading.

However, fairness as a component of market quality should not be limited to the prevention of market abuse: it should include the provision of equal access for all market participants to a trading venue and its absolute neutrality, like regulated exchanges offer – with the most welcomed side effect of heterogeneous liquidity.



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Non-quantifiable but cost-effective

Fairness is not the only component of market quality that cannot be expressed as a figure – there are many factors for an optimum outcome of a single trade defying quantification. Actually, every step in the trading process – from order routing, trading and clearing, down to settlement of each and every instrument – will influence the overall transaction cost. This includes the level of the trading technology of a marketplace – and the provision of redundant lines and co-location services as well as the stability of the trading infrastructure. In addition, the efficiency level of instruments and technical solutions implemented to guarantee sensible prices during highly volatile markets or to prevent unwelcomed side effects of HFT can influence the outcome of a trade. The same goes for the services a market operator offers to support the risk management of investors, such as the provision of a central counterparty.

Market quality and transparency

While a high level of pre- and post-trade transparency may not comply with the business model of every market participant, it certainly contributes significantly to the stability of the European trading landscape – and adds much needed efficiency to the price discovery process in increasingly fragmented markets. Transparency on a pan-European level, however, cannot be obtained without its most important precursor: fairness in terms of market accessibility and the prevention of market abuse. A market model offering equal rights as well as equal trading opportunities for every market participant alike does not only cater to a rich and heterogeneous order flow – it is also future-proof in regard to the expected new requirements coming with MiFID II. ■

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