FESE non-paper on market data services

A rebuttal to the Copenhagen Economics report 'Pricing of market data'

On 28 November 2018 Copenhagen Economics published 'Pricing of market data', a report commissioned by the Danish and Swedish Security Dealers Association. The main conclusions in the 2018 report are that market data fees are 'high' and that 'elevated market data fees have a negative impact on consumers and enterprises.' As explained in this non-paper, this conclusion is flawed and it is based on an incorrect understanding of the functioning of equity trading markets and the core functions of a stock exchange.

1. Understanding the core functions of exchanges

The Copenhagen Economics report appears to describe the core function of a stock exchange as the provision of trading and, in doing so, overlooks the core function of 'price formation'.

1.1. The provision of trading is just one of many core functions of a stock exchange

Stock exchanges undertake a range of activities and fulfil a number of different functions. When stock exchanges are defined, their role is typically captured in terms of their listing services and trading function (or liquidity provision). However, a very important related function of exchanges is that of price formation. The Copenhagen Economics report does not elaborate on this and in doing so presents an inaccurate representation of the functioning of the market data business. Indeed, the report makes no reference to 'price formation' or 'price discovery' and instead describes the core function of a stock exchange as the provision of trading.

Whilst trading is one of the core functions of a stock exchange it is incorrect and misleading to present trading as the key function since a very important related function of exchanges is that of price formation. This is especially true when considering market data services provided by exchanges. Market data is the outcome of the price formation process, and so it is not possible to analyse market data without considering the function of price formation.

1.2. Price formation guarantees quality of financial markets and lower costs of capital

Price formation is the process of determining the price of an asset in the marketplace, and can be seen as the process by which information is incorporated into prices. The price formation function stems from the fact that the 'goods' being exchanged in equity markets are claims to uncertain future cash flows. Therefore, an important function of a stock exchange is the information-gathering and distribution process that ensures that market participants are sufficiently informed about the prices of the assets being traded in the market, so that they can make well-informed commercial decisions.

This function of price formation is widely recognised in the academic literature and by regulatory authorities. The price formation process leads to more efficient and fairer financial markets and a lower cost of capital for business. It has also enabled the development of new products and trading business models, resulting in more choice and competition for trading and new propositions for consumers. The development of such products and business models demonstrates that competition forces are very much at work in this space. The rise of new trading venues has been made possible due to nondiscriminatory access to equity market data of exchanges who provide price formation for all market participants.

2. Understanding the nature of market data services

The Copenhagen Economics report's main conclusion that market data fees are 'high' appears to be based on its observation that the fees exceed the direct costs of distributing market data. As a result, the report fails to take into account other costs, such as the costs of producing data.

2.1. Price formation is not delivered incidentally

A substantial part of the activities undertaken by exchanges contribute to the delivery of a reliable price formation process. This process allows investors to know that the prices they buy and sell at are fair and accurate. In order to deliver reliable price formation and market data services, exchanges invest in hardware and networks, setting trading rules, and monitoring and enforcing compliance with these rules. Most of these activities are undertaken to deliver both trading and price formation. Market data is the outcome of the price formation process. The value of the price formation process, and consequently exchange market data, derives from the speed at which it occurs and is distributed (latency) as well as its quality and reliability. Exchanges have made continuous investments to excel in this respect making exchange market data extremely valuable for a wide variety of market participants.

As previously demonstrated, market data is the outcome of the price formation process. The Copenhagen Economics report however seems to infer that market data is only a by-product, in that it is a subsidiary or secondary product that is produced incidentally, along with the main product 'trade execution'. The Copenhagen report then uses this to argue that only the incremental costs of market data (and not the joint costs) can be taken into account when setting market data fees. This line of argumentation is flawed.

2.2. Market data and transaction services are intrinsically linked

Trading and price formation are closely related functions. Shares are claims to uncertain and imprecisely predictable future cash flows. It is therefore difficult to envisage how shares can be bought and sold without some process by which information is taken into account when prices are determined. Similarly, it is difficult to see how prices could be 'discovered' without some trading taking place. It is not possible to provide transaction services without generating market data, and it is not possible to generate trade transaction – or market depth – data without also supplying a trade execution service. In other words, market data is a joint product with joint costs.

The economics literature suggests that, in the case of joint products, it is efficient to recover costs through fees from both products. This is what exchanges do in practice. Indeed, according to a principle known by economists as 'Ramsey pricing', in the case of joint products it is economically efficient to recover a relatively large part of the costs from those customers whose demand is less sensitive to price than it is for other customers. The efficiency of Ramsey pricing lies in the fact that it tends to lead to higher total output, and hence higher surpluses for consumers. As such, the Copenhagen Economics report, fails to put the costs of market data into the broader context. Market data revenues as a proportion of total revenues (trade execution and market data) account for around 35% across all FESE members. In other words, a large proportion of costs is recovered through trade execution fees rather than market data services fees. In reality, stock exchanges account for a small part of the total value chain for market data (around 10–15% of the total European spending on market data and analysis) and exchanges' market data accounts for a very small part of

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investors' costs of holding and trading in stocks. Furthermore, recent market data fee increases have been small in general (e.g. for Level 1 and Level 2 data, less than 1.5% per year in real terms for most exchanges).

2.3 Market data and best execution

Copenhagen Economics argues that investment firms are obliged to buy market data for the purpose of verifying best execution. The report makes the claim that the best execution requirement in MiFID II establishes the need for security dealers to obtain market data from trading venues. This argumentation is flawed and oversimplifies the meaning of best execution. Indeed, best execution cannot be reduced to price and is much more complex than depicted in the report. Copenhagen Economics claims that MiFID II indirectly puts an obligation of brokers to obtain market data from several trading venues. This is not the case, purchasing data from several venues is not an obligation but rather a business choice that market participants make based on commercial considerations. In reality, a number of brokers only connect to one venue and therefore only use the market data from one venue all the while being fully confident that they are meeting the MiFID II best execution requirements.

3. Understanding the debate from a market design and end-user perspective

The Copenhagen Economics report does not look at the pricing of market data from a market design and end-user perspective. The report focuses on the perspective of a small broker rather than end-investors and does not adequately inform the debate in terms of market outcomes for investors.

3.1. The current charging structure is unlikely to negatively affect market outcomes for investors

From a public policy perspective, the key question that needs asking is whether the current practice of recovering costs through a combination of trade execution and market data fees has negative implications for the functioning of equity markets and their end-users—i.e. investors and companies that are raising capital.

It is important to note that exchange market data accounts for a small proportion of fund managers' overall costs. Copenhagen Economics chooses to look at the costs from the perspective of a small broker. While it is in principle possible that market data fees may have a larger impact on smaller brokers than larger brokers, the key question from a public policy perspective is whether there would be a negative impact on end-investors. Even in the unlikely event that there would be some consolidation among brokerage firms, the subsequent increase in concentration would be small, and would be unlikely to result in a significant reduction in the degree of competition. It is therefore unlikely to affect the end-investors. Furthermore, the report argues that brokers limit their use of market data, and that this would hamper informed investment decisions, but it does not provide any empirical analysis for this.

3.2. Any further changes to the design of the market for equity trading would need to ensure that the price discovery process is not negatively affected

Although MiFID I and MiFID II have been successful in introducing competition and creating a market that delivers well in terms of choice and low trading fees, there is a risk that the growth in equity trading off-exchange will threaten the quality of price formation going forward. Any further changes to the design of the market for equity trading would need to ensure that the price discovery process is not negatively affected.

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When assessing the impact of MiFID II on the market data landscape and contemplating potential changes to the design of the market, FESE urges policy makers to take all of the factors outlined in this non-paper into account to ensure Exchanges' continued ability to operate transparent, fair, orderly and resilient markets which produce high-quality data and price formation.

4. Conclusion

Overall, this non-paper underlines that the Copenhagen Economics report fails to assess the current practice of charging for market data from a market design and end-investor perspective and overlooks the important role of price formation in equity trading markets.

When assessing the market data landscape, the buy-side too often pursues an overly narrow agenda which risks undermining the ability of exchanges to operate transparent, fair and resilient markets. Such an approach would, ultimately, harm the provision of high-quality data and price formation which are key for investors and the financing of the real economy. Indeed, eroding exchanges' business case would inevitably result in adverse consequences for investors, be they retail or professional, and beyond the financing of the economy, economic growth and employment.

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