Keynote Trading Amsterdam

Tanya Pieters-Gorissen, 20th of April

(Only spoken word counts)

Capital markets; challenges and developments

Dear attendees ,

- Thank you for the invitation.

- As the head of Capital Markets Infrastructure and Transparency Supervision, I have the honour to deliver the keynote speech this year. I am taking over the baton from Hanzo van Beusekom, last year's keynote speaker, and Gerben Everts, who delivered the keynote in 2021.

- As a recently appointed head, I was fortunate to join a smoothly running department.

- But spring is a great time to shake things up a bit and to have a close look at the design of our regulation, to determine where changes can and need to be made.

- My own spring cleaning, if you will.

- Keeping an eye out for new insights, new market developments and the latest innovations.

  And a good spring cleaning is needed not only in my own department, but also in the capital markets in general.

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  - At first glance, the capital markets appear well positioned to deal with current issues, which include market turbulence, high volatility, a looming banking crisis and uncertainty in the economy.
  - But if we take a closer look, there are a number of things that deserve our attention. New developments we must anticipate, new rules we must take note of, and points of attention that must be examined every year.

- Addressing these issues is necessary to keep the markets safe and clean. And that's what my keynote speech today is all about: looking at what we need to do to keep the markets attractive and to reinforce their foundations.

- I believe we need to take steps to keep our capital markets attractive. That needs to be a priority, along with keeping the markets liquid, transparent and resilient.

- Last year, the AFM published its first State of the Capital Market report, in which we looked at the main trends in the market structure of different asset classes currently under our supervision, namely equities, fixed-income, commodities and derivatives.

- One of the main trends we looked at was how liquidity has been evolving, particularly for on-venue trading of equities.

- While bid-ask spreads on the Dutch trading venues have been steadily decreasing, we found that the order book has not necessarily become deeper, or in other words: more liquid.

- This gives us cause for concern as to the quality, resilience and attractiveness of the lit market. We are trying to better understand the root causes and to ensure that the capital market remains an attractive source of funding for issuers and investors alike.

- Our first main concern relates to the Capital Markets Union agenda, which seeks to increase on-venue trading by moving trading from dark to lit trading venues where appropriate.

- We welcome the more solid transparency framework put in place by the Markets in Financial Instruments Regulation. But the AFM has genuine concerns about the fact that market participants increasingly seek to diverge from lit central limit order book models. This involves participants shifting to forms of internalisation or to OTC trading, or to alternative types of venues that sometimes even lack the right licences.

- By contrast, the bond markets are seeing a clear increase in on-venue electronic trading, leading to more transparency and less of a clubby environment.

- Our second main concern relates to the growth of systematic internalisers, which have been the subject of much debate. We believe that SIs have an important role to play as alternative liquidity pools, complementing the role of multilateral types of trading venues.

- The added value of SIs is twofold. First, SIs can operate indirectly as dealers and liquidity providers on venues by creating efficiencies in the system.

- But the real added value and main role of SIs is that they offer tailored solutions to their clients, with real skin in the game. Examples include trades above certain sizes, in illiquid instruments that don't contribute to price formation, and to protect clients from undue exposure

- In all other circumstances, a level playing field between SIs and multilateral venues is key. A level playing feel is essential to ensure sufficient visible and transparent liquidity on open, multilateral markets that cater to the needs of investors and issuers alike.

- The matters I have just discussed are issues at a more macro level. But I want to start our spring cleaning by taking a closer look at three other developments, which are particularly relevant from a derivative and proprietary trading perspective. These are:

    - The control over the algorithms
    - Cybercrime and the DORA regulation
    - The definition of a trading venue perimeter

Algorithmic trading

- The first development I want to talk about are algorithms and AI.

- As you know, algorithmic trading has been the main way of trading on the Dutch equity and exchange-traded derivatives (or ETD) markets for over a decade.

- Roughly seventy percent of transactions are executed by trading algorithms.

- The research we published in March showed that between eighty and one hundred percent of trading algorithms use some form of Machine learning "under the hood".

- Technological advancements like AI and new techniques create opportunities for markets to become more integrated and efficient. But these techniques also raise questions.

- When trading algorithms become more complex and perhaps more difficult to untangle, that raises two questions about the concept of explainable AI .
    - First, to what extent do we really understand the inner workings of these algorithms and to what extent are we able to fully explain them?
    - And second, perhaps more importantly, is there even a need for explainable AI if algorithms are properly controlled?

- In any case, proper testing of trading algorithms is becoming ever more important. This requires that trading venues and trading firms have sufficiently realistic testing environments.

- Furthermore, firms should make sure that their trading algorithms are at least understood by their staff.

- This includes the second line of defence. This may be challenging, especially given the sheer complexity of many models.

- But understanding and being able to explain the workings of AI is not enough. The flash crash in May 2022 showed that we also need robust controls, which are checked regularly and tailored to specific trading activities.

- During the flash crash, share prices on European stock exchanges plummeted by 8%. This happened at such a lightening speed that trading even had to be suspended. The crash turned out due to be a human error, which was not recognised as such by the algorithms. Algorithms don't know and don't care whether an order entry is a mistake. So they simply executed the orders in milliseconds.

- Besides the challenges around the control, understanding, and explaining of algorithms, it has been pointed out by scientists that the emergence of new machine learning techniques may also lead to new, cunning forms of market manipulation. This poses challenges for our surveillance and supervision, but possibly also for you.

- Investment firms should be aware of the possibility of using advanced self-learning techniques to manipulate the markets.

- But firms also face the risk of their trading algorithms *being* manipulated. Such manipulation might be subtle or go unnoticed, especially when trading algorithms use many inputs and their inner workings are not fully understood.

- All in all, an intriguing development. For us as a regulator, and for you as well.

- That's why I hope that next year we will be able to discuss this theme in order to exchange experiences.

Cybercrime and the DORA regulation

- Unfortunately, along with the increase in the use of algorithms, we are also seeing a growth in cybercrime. The challenge is how to deal with it.

- Above all, the trading chain needs to remain reliable and robust.

- The regulatory framework has not yet been fully adjusted to this reality. And most firms have not yet protected themselves against this threat as best as possible.

- According to National Coordinator for Counterterrorism and Security (NCTV), Dutch organisations are becoming increasingly resilient to hackers.

- However, that growing resilience continues to lag behind the increasing cyber threat. So if I were a hacker, I would be going after a law firm or investment firm, because that would certainly be a lucrative venture.

- What a wealth of price-sensitive information you would find there. And image all the things you could do with that information, from blackmail to selling it on the dark web.

- So the introduction of European legislation in this area, in the form the Digital Operational Resilience Act, is certainly very welcome.

- The purpose of DORA is not to penalise firms, but to ensure a high level of awareness and to limit potential risks. DORA sets a standard in the field of ICT resilience and risk management in the European financial sector.

- Financial market participants must be fully DORA compliant by 17 January 2025. But for most market participants, probably also including firms represented here today, many of these requirements are not entirely new.

- Together with the national competent authorities, ESMA is currently drafting DORA related regulatory technical standards (or RTSs).

- We expect that many of these RTSs will be published over the course of this year. They will undoubtedly provide more guidance on the implementation of DORA.

- During the implementation phase, the AFM will closely monitor the progress made by market participants. To this end, the AFM will continue to launch DORA related thematic reviews.

- You know what job you need to get done. I can imagine that you are also curious what the AFM is going to do.

- Our focus next in the coming year will be on creating awareness and urging market participants to make timely preparations and to map the compliance gap. So that means ensuring that market participants identify what measures and actions they need to take to be fully compliant.

- We will share the findings of the thematic reviews with the market, and we will follow on these findings in our regular supervisory meetings with market participants.

Trading venue perimeter

- The last subject I want to talk about is the recent ESMA opinion that has provided clarity as to when systems operated by market parties qualify as multilateral systems.

- You may have wondered why ESMA released this comprehensive opinion.

- That reason for that is actually very simple. Because we all want transparent and robust markets, don't we? And aren't we all in favour of a level playing field?

- With the ESMA's opinion, the foundations for this have been reinforced.

- It has become clear that the distinction between a regulated multilateral venue and a technology/communication platform is thin. That holds true for all types of instruments on data-driven and electronic markets.

- The introduction of MiFID II has significantly increased the regulatory burden for operating a trading venue. This has incentivized firms to avoid these costs and to operate close to or beyond regulatory delineations. Sometimes even unintentionally.

- A complicating factor is that the trading venue licensing requirements are part of the MiFID II directive rather than the regulation. This has led to national transposition and interpretation issues around the definition of a multilateral system.

- The new MiFI Regulation will transfer the licensing obligation for trading venues from the directive to the regulation. This should create more legal certainty about what constitutes a multilateral system and to what extent it is subject to the full regulatory framework.

- The recently published ESMA opinion on the trading venue perimeter should provide more clarity in the short term. The AFM has also defined this as a key priority.

    - That is because trading venues operating without the applicable licence are at risk of not complying with multiple legal requirements. That means they may not have properly controlled business operations and may be exposed to stability risks. They may also lack an adequate governance structure and measures to protect client rights. And they may fail to comply with transparency requirements and other prudential and market conduct supervision requirements.

    - Trading venues operating without the applicable licence also create an unlevel playing field. Such illegal platforms have an unfair competitive advantage because they are not subject to the financial and operational burdens that come with supervision and the related regulations to ensure a transparent and robust market. This cost advantage is unfair and may also lead to the market moving to these illegal platforms and thus falling completely outside the scope of our supervision.

- The AFM regularly receives signals from the market on a confidential basis that market parties may be operating in the Netherlands without having the required licence. That's harmful to the functioning of the capital markets. And such activities are also at odds with the AFM's mission of ensuring fair and transparent capital markets.

- Further to its opinion, ESMA expects the national competent authorities to oblige market participants to take appropriate measures to quickly apply for a licence as a trading platform if necessary. This has created a clear momentum for the AFM to call on such trading platforms to apply for the correct licence.

- Given the clarity that the ESMA opinion provides, we are following up on this and we are continuously assessing whether market parties meet the requirements and are applying this opinion.

- I would like to emphasize that it is not the AFM's aim to put more trading platforms under our supervision. Our goal is to allow parties that behave like a trading platform to operate under the required licence to ensure fair and transparent capital markets.

Ladies and Gentlemen,

- Today's keynote was all about spring cleaning on the capital markets and how to keep the market attractive.

- I've discussed three developments: the algorithms, operational resilience in a digital environment, and clarity around the trading venue perimeter.

- I have discussed them in a time frame of five minutes per subject, but I am well aware of the complexity.

- And I'm aware that you have to deal with more challenges. Or actually, that <u>we</u> have to deal with more challenges.

- Because let's face it, to some extent your problems are automatically our problems. And we also have to work together to keep our capital markets attractive, liquid, transparent and resilient.

- Therefore, we will have to tackle the challenges I've talked about, but also the upcoming amendments to the MiFIR regime, the new EMIR proposals, more strict governance requirements, and potentially even another crisis on the gas futures market. And last but not least, the ESG regulations.

- Yes, ladies and gentlemen, you can say a lot about the capital markets, but they are certainly not boring.

- At the beginning of my keynote, I told you that for me, this year's spring is about shaking things up a bit.

- That applies to my department, but – as I have tried to point out – also to the capital markets.

- And although I would like to complete all the tasks before us in the blink of an eye, I was taught not to tackle too many problems at once. Because then we won't be able to get any of these jobs done properly.

- Let's determine together how we can address the challenges in a sensible way. Not too fast, but of course not too slow either. So that at next year's Capital Markets Day, we can look back and say: that was a job well done.

- Thank you for your attention.