

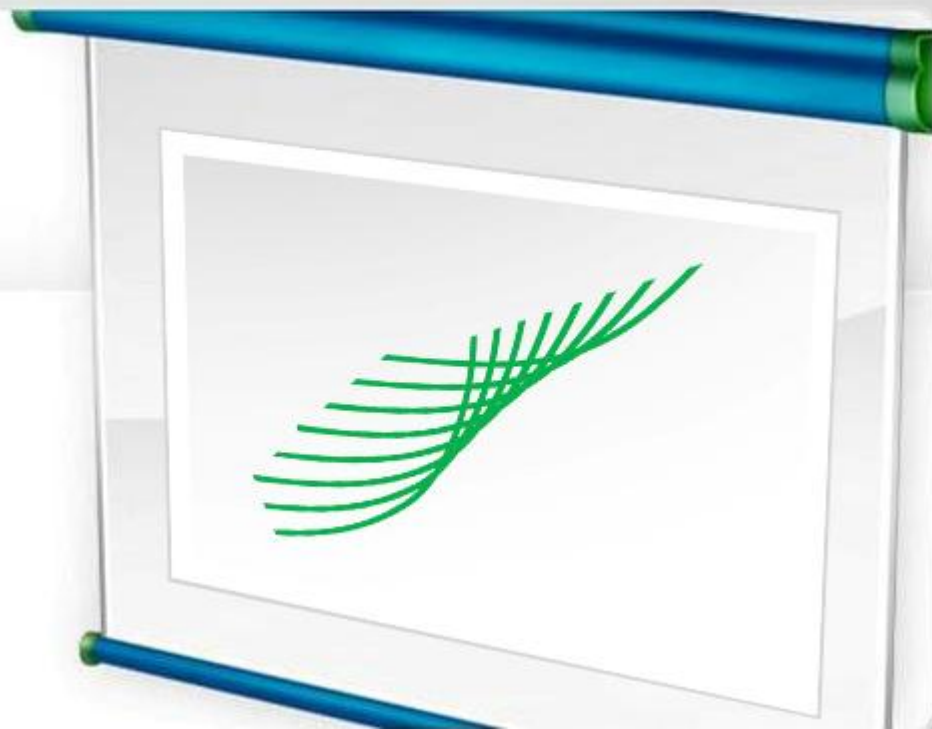
BM&FBOVESPA

A Nova Bolsa



**DEBATE PROMOTED BY THE CVM
ON THE OXERA CONSULTING
REPORT**

06/29/12



CLASSIFICAÇÃO DA INFORMAÇÃO (MARQUE COM UM "X"):

CONFIDENCIAL RESTRITA CONFIDENCIAL USO INTERNO PÚBLICO

i. INTRODUCTION

ii. CONSIDERATIONS ON THE OXERA CONSULTING REPORT, THE COSTS AND BENEFITS OF COMPETITION BETWEEN EXCHANGES AND MARKET FRAGMENTATION

iii. PROVISION OF CLEARING SERVICES BY THE BVMF TO OTHER TRADING PLATFORMS

iv. CONCLUSIONS

i. INTRODUCTION

ii. CONSIDERAÇÕES SOBRE O RELATÓRIO DA OXERA CONSULTING E SOBRE OS CUSTOS E BENEFÍCIOS DA COMPETIÇÃO ENTRE BOLSAS E FRAGMENTAÇÃO DO MERCADO

iii. PRESTAÇÃO DE SERVIÇO DE CLEARING PELA BVMF PARA OUTRAS PLATAFORMAS DE NEGOCIAÇÃO

iv. CONCLUSÕES

INITIATIVE BY THE CVM

- The BVMF would like to congratulate the CVM for its initiative to promote an open and transparent discussion about the functioning and efficiency of the Brazilian capital market with all stakeholders.
- It is vital for the development of the capital market that the regulator constantly brings about reflection on the market structures, functioning and rules.
- One of the greatest differentials of the Brazilian market over the last decade was the critical thought and the initiatives taken by regulators and self-regulators, specifically:
 - the creation of the new Sistema de Pagamentos Brasileiro –SPB (Brazilian Payment System) ;
 - the evolution of a regulatory benchmark for the fund industry;
 - strict surveillance promoted by the CVM and the efficient introduction of commitment terms;
 - the creation of the Novo Mercado (New Market); and
 - the creation of the Programa de Qualificação Operacional –PQO (Operational Qualification Program)

WHY IS COMPETITION IMPORTANT?

- We consider competition important because it can improve consumers welfare.
- In general, improvements in consumers welfare can be understood as :
 - Reductions in the price of the goods or services consumed; and/or
 - Improvements to the quality of goods or services consumed.
- For this reason, we consider that the CVM approach to discuss competition between the exchanges in terms of costs and benefits to investors is appropriate.

COMPLEXITY OF THE DISCUSSION

- Discussions on price and quality within the scope of the capital markets are not trivial
- In fact, the capital markets' complexity, risks and sophistication cause price and quality to assume different dimensions and perspectives

PRICE

- Transaction fees
- Trading implicit costs
- Market size/ extent
- Investment in technology
- Brokers costs
- Regulatory costs

QUALITY

- Investors confidence
- Issuers confidence
- Conflicts of interest
- Liquidity fragmentation and price formation
- Systemic risk
- Moral hazard
- Complexity of regulation

COMPLEXITY OF THE DISCUSSION

- As highlighted in Oxera's report, it is difficult to assess certain elements of the discussion about price and quality (for example, the implicit costs of liquidity fragmentation)
- Incidentally, others may be even difficult to understand:
 - What were the causes of the May 6th, 2010 flash crash and the successive mini flash crashes in the US market?
 - To what extent market fragmentation and the prevalence of HFT transactions – largely the result of fragmentation itself – may generate instability in the markets and in the price formation process?
 - What is the impact of such process on investors and issuers confidence?

COMPLEXITY OF THE DISCUSSION

- Despite the complexity of the topic, BVMF understands that the discussion about the capital markets efficiency is justifiable and necessary
 - We also think this is a topic that deserves serious and in-depth discussions
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GENERAL IMPRESSIONS BY BVMF ON THE REPORT

- Despite the technical quality of the team that prepared the report, it frustrated the expectations of the BVMF that expected it to provide further clarity for the discussion on the costs and benefits of market fragmentation

As we will argue, the report underestimates:

- i. The implicit costs of liquidity fragmentation
- ii. The IT costs and those of brokers, custodians and clearing members processes
- iii. The regulatory costs

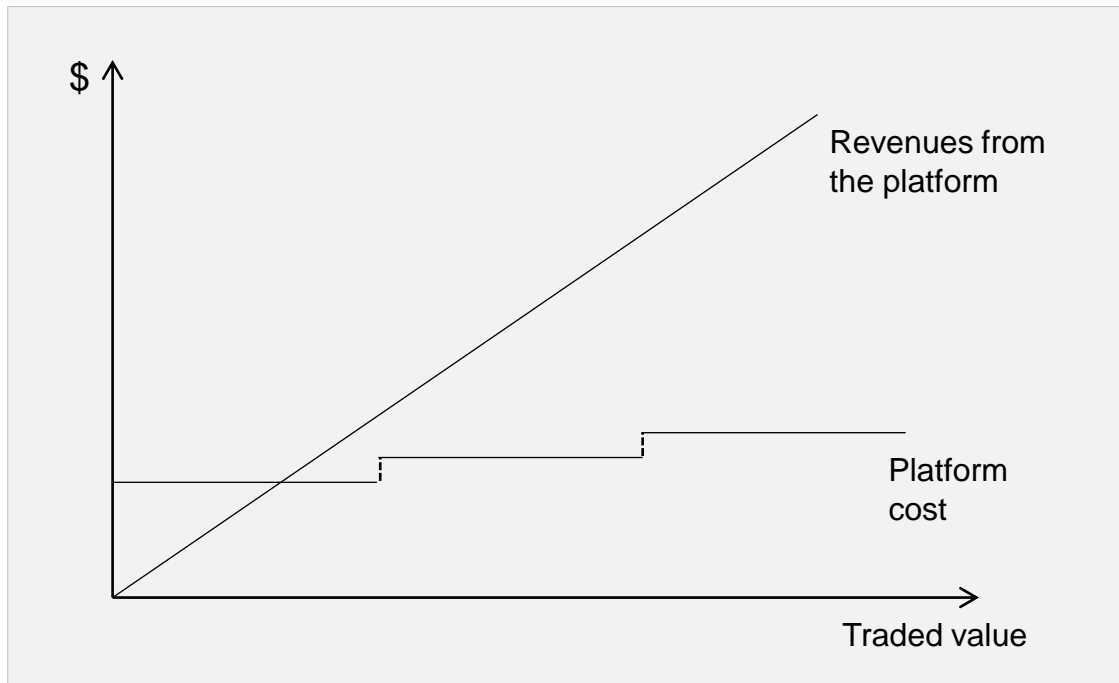
The report also fails as regards the comparative analysis of the prices and the estimate of benefits:

- i. It fails to properly include the peculiarities of the beneficiary-end owner model adopted in Brazil
- ii. It practically fails to approach the question of the all-in cost for end-investors to trade on the secondary market, almost certainly the most relevant measure for purposes of price comparison
- iii. It overestimates the benefits deriving from price reductions

SCENARIO	MAIN BENEFITS	MAIN COSTS
<p>Competition between trading platforms</p>	<ul style="list-style-type: none"> • Pressure on trading fees • Incentives to innovation 	<ul style="list-style-type: none"> • Liquidity fragmentation and impact on the price formation process • Prevalence of HFTs • IT costs for brokers • Regulatory costs for the CVM • Challenges for the management of pre-trading risk
<p>Competition between trading platforms and clearing platforms</p>	<ul style="list-style-type: none"> • Pressure on clearing fees • Incentives to innovation 	<ul style="list-style-type: none"> • IT costs for brokers, custodians and clearing members • Regulatory costs for the BACEN • Less efficiency in terms of capital allocation • Incentives to competition between risk systems may create systemic risks

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- There are significant economies of scale in terms of trading platforms and clearing services
- The average cost per trade declines with the growth in trading volumes



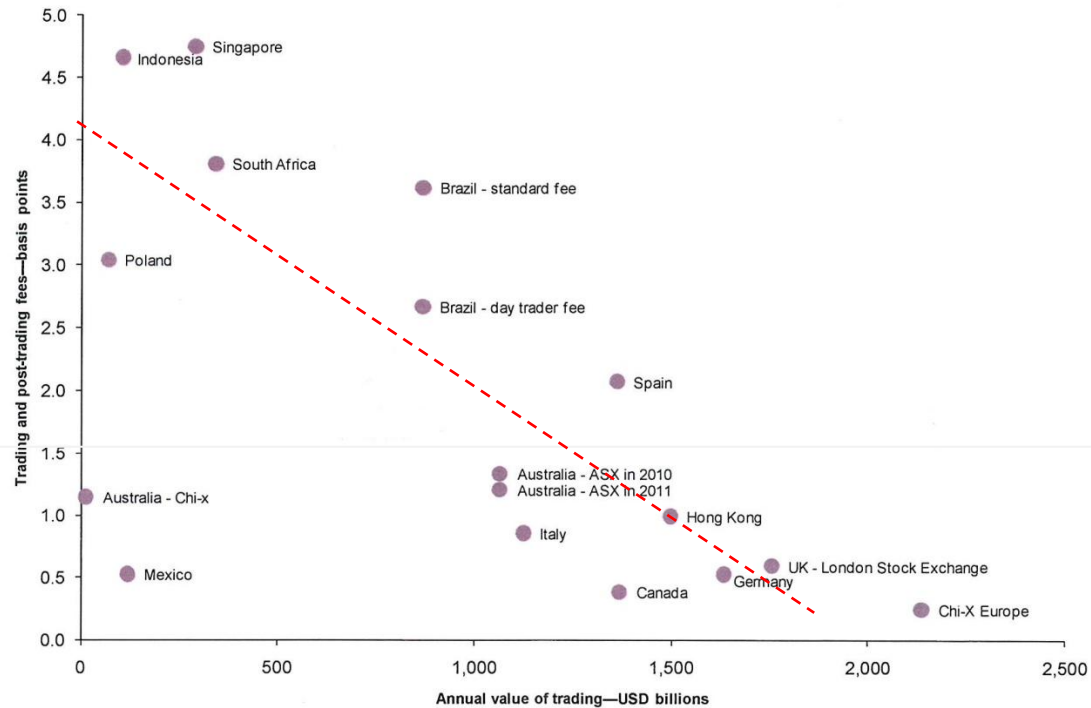
- The data presented in the Oxera report leads us to conclude that BVMF's trading and clearing fees are at the same level as those applied in other world markets, when the following items are taken into consideration:

a) **The market size and the respective economies of scale;** and

b) **Differences between the services rendered by the various exchanges – specially the settlement of end-clients' accounts at BVMF's CBLC, that involves:**

- Management of more than two million accounts of end-clients (individuals, funds, financial institutions, non-resident investors, non-financial legal entities)
- Transfer of securities directly from and to end-clients' accounts;
- Dividends settlement directly in the account of end-clients, including any assistance to calculate taxes;
- Provision of information to custodians and issuers at the beneficiary end-owner for purposes of data conciliation
- Issuance and mailing of custody statements, trading notices and asset transfer notices, thus **enhancing the control mechanisms and contributing to investors' safety.**

Figura 4.6 Relação entre o custo de negociação e pós-negociação e o montante de negociação—investidores institucionais que utilizam grandes intermediários

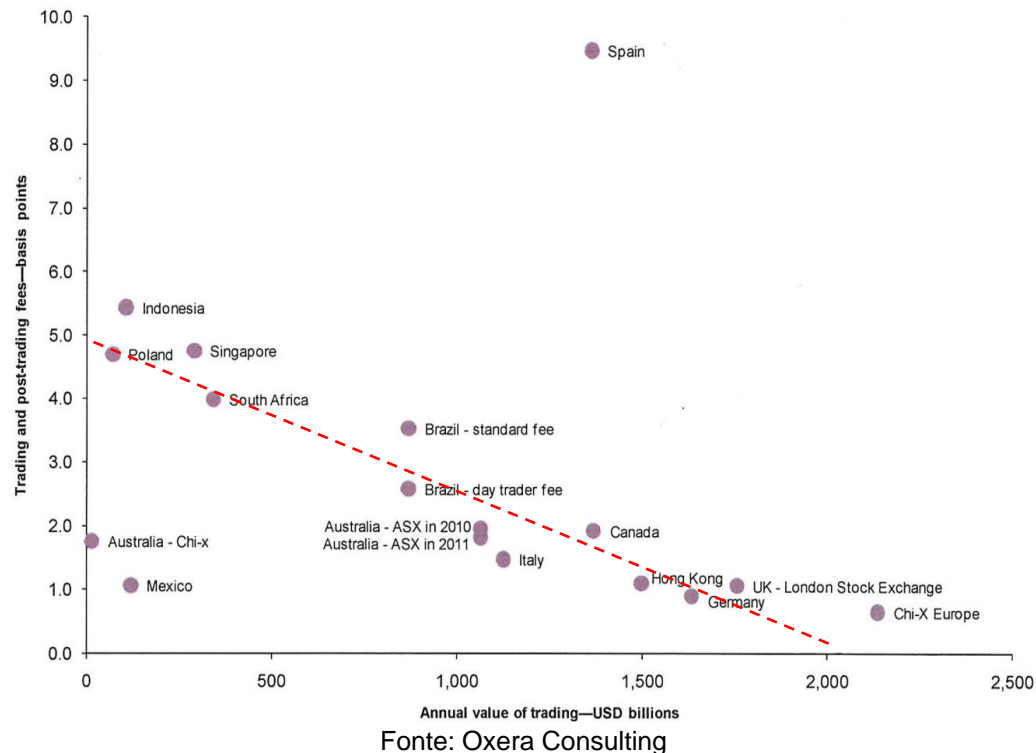


Fonte: Oxera Consulting

Services provided by the BVMF and other entities are not comparable due to settlement on end-client s accounts

The BVMF fees should be adjusted downward or the fees of the other exchanges adjusted upward.

Figura 4.7 Relação entre o custo de negociação e pós-negociação e o montante de negociação—investidores de varejo que utilizam pequenos intermediários



Services provided by the BVMF and other entities are not comparable due to settlement on end-client s accounts

The BVMF fees should be adjusted downward or the fees of the other exchanges adjusted upward.

ALL-IN COST FOR INVESTORS

- All-in cost for investors **is the amount that they effectively pay to buy and sell shares on the secondary market**
- Therefore, they are as relevant or more than the trading and clearing fees, separately considered, to assess the capital markets efficiency
- The Oxera report disregards the discussion on the all-in cost for investors – especially institutional investors – and its importance for purposes of comparing the efficiency of different markets

ALL-IN COST FOR INVESTORS

- The report stresses that trading and clearing fees in the USA (NYSE + DTCC) are **13-27 times lower** than those charged in Brazil
- It happens that the US market trading volume is **70-80 times** greater than that in the Brazilian market. It is expected that the magnitude of such economies of scale causes an impact on the fees charged by the NYSE and the DTCC.
- **However, and surprisingly, despite the enormous difference of scale between the markets, the all-in cost for institutional investors in the US market is very similar to the all-in cost for institutional investors in the Brazilian market.**
- The Oxera report seriously fails once it does not give due importance to such issue

- **A research conducted by the BVMF with various North-American institutional investors reveals that the total cost of trading in the US for this type of investor is between US\$0.01 and US\$0.04 per traded share**

Comparison with Brazil:

- Weighted average price per Ibovespa share: US\$ 15.00/share
- Trading fee (0.007%) plus settlement fee (0.0275%): 0.0345% (*)
- Brokerage fee: 0.01%; 0.05% or 0,10%

		Total Cost of Trading	
Brokerage Fee	Exchange Fee	Total (%)	Total US\$/share
0.01%	0.0345%	0.0445%	US\$ 0.0067
0.05%	0.0345%	0.0845%	US\$ 0.0127
0.10%	0.0345%	0.1345%	US\$ 0.0202

(*) The settlement fee charged by the BVMF from investment funds is lower, equal to 0.018%

- In the only instance in which it considers the total cost for investors relating to the retail segment (for which it is easier to obtain data), the Oxera report concludes that, despite the scale substantially higher of the English market, the average costs in the Brazilian market are lower than those in England,

Tabela 4.4 Tarifas de corretagem de varejo no Brasil e no Reino Unido

Corretor de varejo	Encargo por negociação (US\$)
Min. da amostra do Brasil	6.64
Max. da amostra do Brasil	34.09
Média da amostra do Brasil	14.44

Corretor de varejo	Encargo por negociação (US\$)
Min. da amostra do Reino Unido	8.88
Max. da amostra do Reino Unido	20.01
Média da amostra do Reino Unido	14.92

Source: Oxera Consulting

DOUBTS ON THE ESTIMATE OF BENEFITS

- The Oxera report states that the average cost of trading at the BVMF – including clearing, settlement and custody – is 3.87 bps on the traded value (table 8.9 of the report)
- Data of the 2011 balance sheet shows:
 - BVMF income from equities trading and settlement : R\$799,1 million
 - BVMF income from custody fees: R\$69 million
 - Financial value traded (one side of the market): R\$1.571.968 million

$$\frac{(799,1 + 69)/2}{1.571.968} = 2,86\text{bps}$$

- A reduction from 3.87 bps to 2.32 bps (Oxera's more aggressive scenario) would be equal to a 40% discount and a benefit of US\$268.9 million (table 8.9 of the report)
- A reduction from 2.86 bps to 2.32 bps would be equal to a 18% discount and a benefit of US\$122 million
- However, in addition to that, the basis used in the report for calculating the benefit is wrong, as it considers income from options and public offers (including Petrobras), among other smaller income
- If the discount and the basis are adjusted, the benefit would fall from US\$268.9 to US\$88.9 million

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LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

- High Frequency Trading (HFT) accounts for 8-10% of the value traded on the BVMF
 - The BVMF recognizes the importance and contribution of HFTs, but it is concerned with the phenomenon of “HFTs prevalence” in fragmented markets, as explained below.
-

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

- Liquidity fragmentation is likely to cause imperfections in asset price formation
- High-Frequency Trading (HFT) strategies in a fragmented liquidity market are designed to capture trading and profit from such imperfections; they are imposed on other investors in the form of a mandatory fee

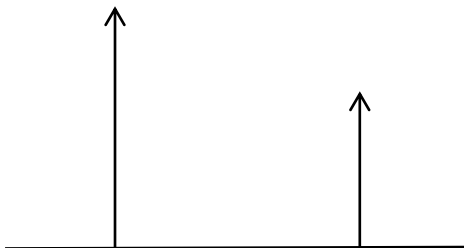
- HTFs profits in a fragmented environment is offset by losses suffered by medium and long term institutional and retail investors

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04



Investor offers a bid price of 9.99 Investor offers an asked price of 9.98

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.99	
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

A matching engine rule that determines that the trade is to be closed at the hit or taken price

Trade is closed at 9.99

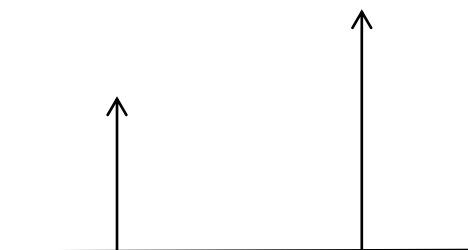
Seller improves his price by 0.01

Investor offers an asked price of 9.98



LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
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Investor offers a bid price of 9.99 Investor offers an asked price of 9.98

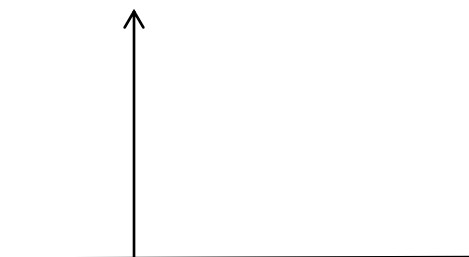
LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
	9.98
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

A matching engine rule that determines that the trade is to be closed at the hit or taken price.

Trade is closed at 9.98

Buyer improves his price by 0.01



Investor offers a bid price of 9.99
Investor offers an asked price of 9.98

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

Platform A

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

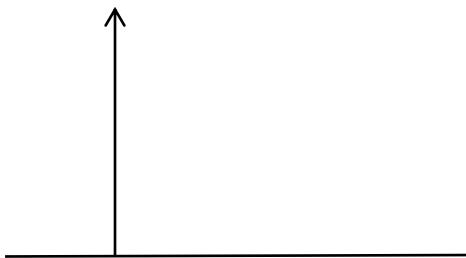
Platform B

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

Initially, the prices in the two platforms are perfectly arbitrated

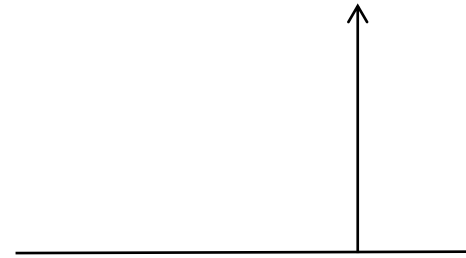
LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04



Investor offers a bid price of 9.99

BID	ASK
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04



Investor offers an asked price of 9.98

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK
9.99	
9.97	10.00
9.96	10.01
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BID	ASK
	9.98
9.97	10.00
9.96	10.01
9.95	10.02
9.94	10.03
9.93	10.04

LIQUIDITY FRAGMENTATION, PRICE FORMATION AND HFT PREVALENCE

BID	ASK		BID	ASK
9.99	←-----	HFT	-----→	9.98
9.97	10.00	Sells at 9.99 and buys at a 9.98, earning 0.01	9.97	10.00
9.96	10.01		9.96	10.01
9.95	10.02		9.95	10.02
9.94	10.03		9.94	10.03
9.93	10.04		9.93	10.04

- In the original scenario, the buyer or the seller improved the price by 0.01
- In the fragmented market, the earnings of the buyer/seller is held by the HFT
- On a fragmented market a mandatory fee is charged on institutional and retail investors; such fee is collected by the HFTs
- In fact, fragmentation may double the value of trades, given that the HFTs come to act as intermediaries between buyers and sellers in different platforms

- The Oxera report argues without presenting any convincing evidence that the implicit costs of liquidity fragmentation tend to be marginal
- According to the Tabb Group consulting firm, the HFT industry profits are estimated at between **US\$8 and US\$20** billion p.a. in the USA alone. How much of that profit results from liquidity fragmentation and is to the detriment of other investors?
- Why do HTF transactions account for more than 60% of the total value traded in the US equities market, the world's most fragmented market? And why do they account for more than 35% of the total value traded in Europe, the second most fragmented market?
- Why are HFTs among the main shareholders and supporters of alternative trading systems? How much do they earn with liquidity fragmentation?
- How will the HFTs prevalence in the Brazilian market affect the confidence of retail investors, long-term institutional investors and issuing companies?

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- The Oxera report underestimates the IT additional costs that would result from brokers connection to different trading platforms and different clearing platforms
- There are 85 brokers connected to the Bovespa segment managed by the BVMF
- The report states that, based on international experience, less than half of the brokers should connect with the new platform
- What would happen to brokers not connected to the new platform? Would they be able to guarantee the provision of best execution to their clients? Would they be at a competitive disadvantage vis-à-vis the connected brokers? Would major clients accept to operate with brokers who are connected with only a part of the market?

- The report overlooks the competition costs that would be incurred by brokers not connected to the new platform. These costs would likely increase with the market share of the new platform.
 - Therefore, the methodology to estimate the brokers' additional costs should take into account the connection of all brokers to the new platform, so as to maintain market fairness and the same conditions of access and competition
-

NETWORK LINKS

- 20 Mbps network link with contingency : R\$20.000,00/month or R\$240.000,00/year
- 85 brokerage firms connected to the BVMF-managed Bovespa segment
- **Industry s additional costs with network links: $85 \times R\$240.000,00 = R\$20.400.000,00$**

TRADING SCREENS

- Average of 15 Bovespa segment s operators per brokerage firm
- Cost of the trading screen provided by the BVMF: R\$300,00 per month per operator
- Average cost of trading screen provided by an independent technology company: R\$1.000,00 per month by operator
- **Additional cost of the industry with trading screens: $85 \times 15 \times (R\$1.000 - R\$300,00) \times 12 = R\$10.710.000,00$**

BACK-OFFICE SYSTEM

- The BVMF also provides a complete administration back-office system to brokerage firms, the SINACOR
- The average price paid by brokerage firms for the SINACOR is R\$10.000,00/month
- The BVMF has a **zero profit margin** policy with the SINACOR
- A similar software available in the domestic market – used by various custodians – costs no less than R\$50.000,00/month
- The replacement of the SINACOR by a system that would support multiple clearings would bring about additional costs for brokers:
- **Additional cost to the industry with back-office systems: $85 \times (R\$50.000,00 - R\$10.000,00) \times 12 = R\$40.800.000,00$**

IT COMPONENT	ANNUAL COST FOR THE INTERMEDIATION INDUSTRY
Network links	R\$20.400.000,00
Trading screens	R\$10.710.000,00
Back-office systems	R\$40.800.000,00
Total	R\$71.910.000,00
Smart order routing, aggregation of market data, best execution, home-broker, DMA	?

- The IT additional cost for brokers under a competition scenario between trading platforms would be at least 2.5 -5.5 times higher than the Oxera-estimated value
- The IT additional cost for brokers under a competition scenario between trading and clearing platforms would be approximately 12 times higher than the Oxera-estimated value
- The Oxera report fails when it disregards the competition costs and the subsidies offered by the BVMF for trading screens and back-office systems

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- In a scenario in which competition exists only between trading platforms, the Oxera report estimates that the regulator may be expected to incur an additional cost of **US\$10,3 million per annum**
- In a scenario in which competition exists between trading platforms and clearing platforms, the Oxera report estimates that the regulator may be expected to incur an additional cost of **US\$10.5 million per annum**, therefore **only US\$200 thousand more per annum than in scenario 1**
- The report must recognize that the CVM is equipped with a team that regulates and supervises the exchange environment, whereas the BACEN has a separate team that regulates and supervises the clearing environment and the CCP

- Therefore, to estimate that the BACEN would incur additional regulation costs of US\$200 thousand – equivalent to only 1 or 2 employees, depending on their qualification – doesn't seem reasonable to us
 - **In our opinion, the report should recognize that, in the absence of an extremely efficient regulation/supervision by the BACEN, the competition between clearing platforms could introduce substantial systemic risks in the market, as it could create economic incentives to make the risk management standards less strict**
-

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- The end-client model used in Brazil allows the adoption of a robust pre-trade risk management model
- All orders transmitted via DMA (direct market access) show the end-client identification
- Pre-trade risk management means verifying the client's risk/credit limit before sending his orders to the trading platform, thus preventing trades to be closed by clients with no risk/credit limit available.
- The adoption of a pre-trade risk management system mitigates systemic risks and risks introduced by high-frequency trading
- As manager of the trading platform and of the clearing house as well, acting as a counterparty to trading, the BVMF has strong economic incentives to use robust and efficient pre-trade risk systems.

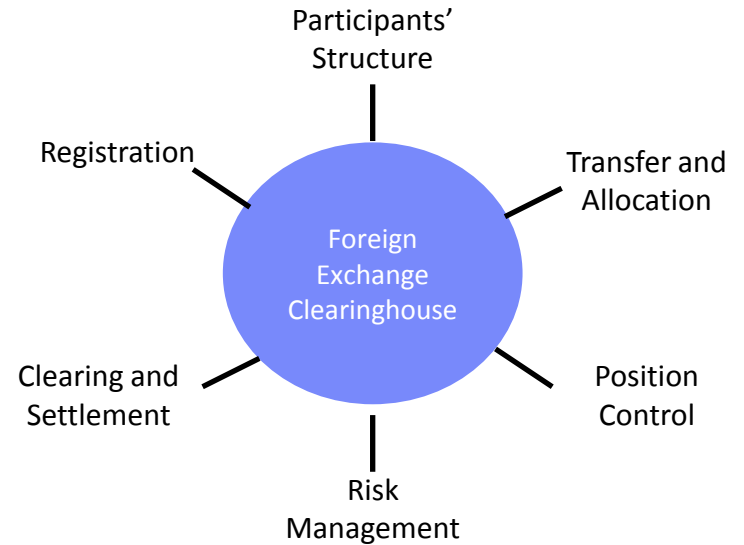
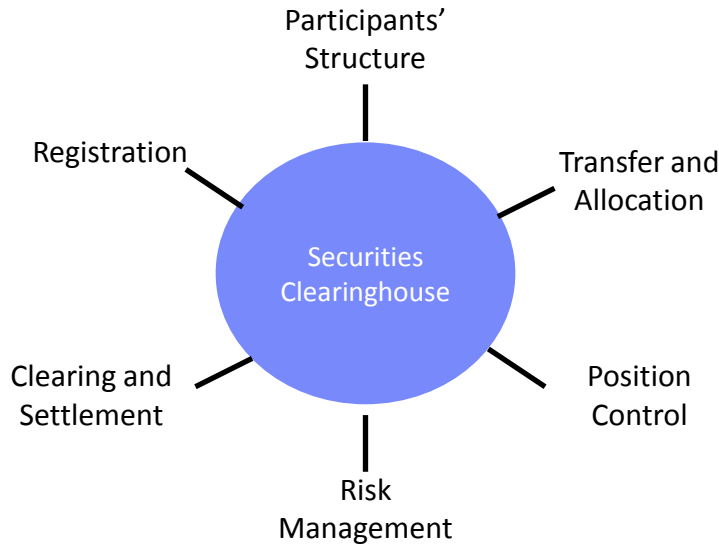
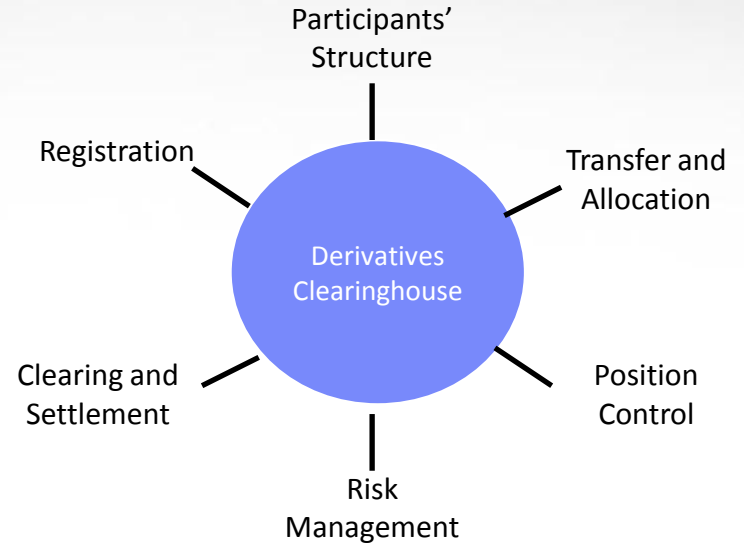
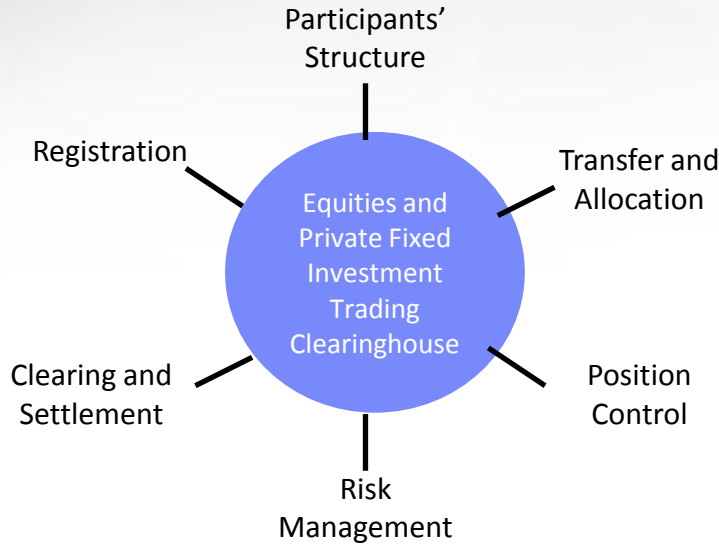
i. INTRODUÇÃO

ii. CONSIDERAÇÕES SOBRE O RELATÓRIO DA OXERA CONSULTING E SOBRE OS CUSTOS E BENEFÍCIOS DA COMPETIÇÃO ENTRE BOLSAS E FRAGMENTAÇÃO DO MERCADO

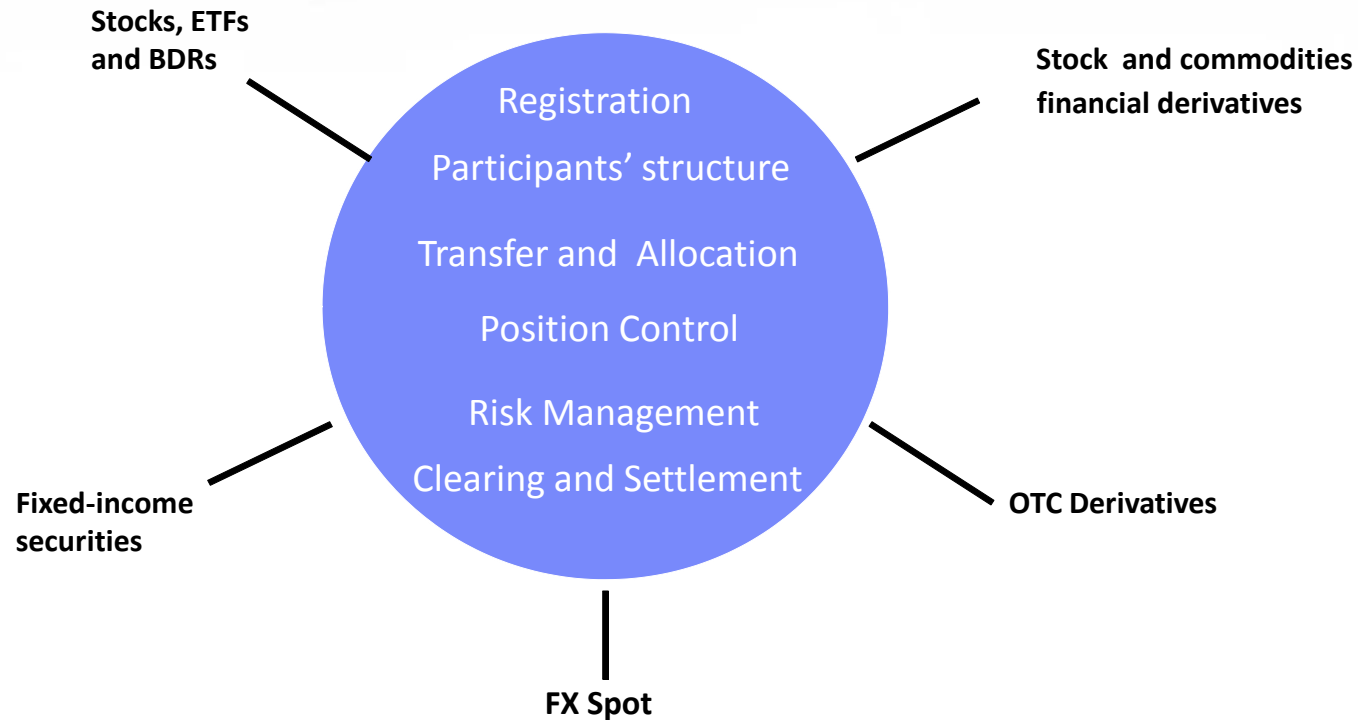
iii. PROVISION OF CLEARING SERVICES BY THE BVMF TO OTHER TRADING PLATFORMS

iv. CONCLUSÕES

- The BVMF is engaged in an ambitious and complex project to integrate its four clearings and to develop an integrated risk assessment system that will result in large benefits to the market, such as :
 - More operational and back-office efficiency in the market;
 - More capital efficiency in trade settlement;
 - More capital efficiency in the allocation of guarantees due to the calculation of integrated risk
- Today, the BVMF has R\$180 billion deposited as guarantee with the four systemically important clearings under its management



INTEGRATED CLEARING NEW STRUCTURE



- Optimization of back-office procedures and reduction of operating costs
- Efficiency in the allocation of investors capital

i. INTRODUÇÃO

ii. CONSIDERAÇÕES SOBRE O RELATÓRIO DA OXERA CONSULTING E SOBRE OS CUSTOS E BENEFÍCIOS DA COMPETIÇÃO ENTRE BOLSAS E FRAGMENTAÇÃO DO MERCADO

iii. PRESTAÇÃO DE SERVIÇO DE CLEARING PELA BVMF PARA OUTRAS PLATAFORMAS DE NEGOCIAÇÃO

iv. CONCLUSIONS

- We consider that the CVM approach to discuss competition among the exchanges in terms of costs and benefits to investors is appropriate
- However, as regards the Oxera report, we think that various aspects of the analysis need to be better developed and deserve thorough, in-depth analysis:
 - Implicit costs of liquidity fragmentation are underestimated
 - Brokers, custodians e clearing members IT costs are underestimated
 - Regulation costs are underestimated
 - The benefits resulting from price reductions are overestimated due to calculation and/or methodology problems. We suggest that the presented data be validated with the other exchanges used in the comparisons.
 - Price comparisons between international markets need to be adjusted so as to reflect the peculiarities of the beneficiary-end owner model in Brazil
 - The all-in cost of end-investors for trading on the secondary market must be incorporated into the analysis, otherwise the conclusions on costs and benefits will become pointless