Q2 2020 Earnings Call

Company Participants

- Marcela Bretas, Investors Relations

Other Participants

- Unidentified Participant

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Audio Conference Call about the ICVM 461 Public Hearing. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions to participate will be given at that time. (Operator Instructions) As a reminder, this conference is being recorded and broadcasted live via webcast. The replay will be available after the event is concluded.

I would now like to turn the conference over to B3.

Marcela Bretas

Good morning, ladies and gentlemen. Hope everyone is well and thank you very much for attending this call. As you may know, at the end of last year, CVM Brazil's regulatory body launched a public hearing process about potential changes in regulation for the securities market in Brazil. In today's call, we will present B3's answer, explaining the underlying rationale and answer any questions you might have. We have here with us Mario Palhares, who is the Director of Listed Products at B3 and (inaudible) Director of (inaudible) Relationship at B3, both of which have led internal efforts to prepare our answers to this public hearing.

I will now turn to Mr. (inaudible) for him to briefly conduct the presentation. (inaudible)?

Unidentified Participant

Thank you, Marcela. Hello, everyone. I hope everyone is healthy at home or at work. It's a pleasure to be here. We prepared a very short presentation with five or six slides to cover the main topics of discussion and demand, views and positions delivered by B3 to the Securities Commission within this discussion.

So this public hearing is split into three different blocks. There are three different draft of rules. The first one touching on the rules that applies on organized markets in Brazil, notably exchange, but also some specific kinds of OTC platforms. The draft two covers the requirements and the rules that regulates the self-regulatory organization services, or SRO, as it is commonly referred to. And Draft 3 is that the execution and minimum requirement supplies on the intermediaries in this context.

Starting the presentation with Slide number 4, that you have in front of you, we start in the Draft A of the hearing touching on some key points of the discussion. So it's important to have in mind that this hearing or this proposal of change in the rules has as a context the potential fragmentation of the Brazilian markets. So certain topics currently are not that relevant, but will become relevant if one day, we have the Brazilian markets fragmented, the exchange markets fragmented in Brazil.

So the first topic in this context is clock synchronization. So here it's very important that all trading venues and all intermediaries connected to these trading venues should use the same standard and also the same source as a clock synchronization or to provide the clock synchronization. This is very relevant to assure that all venues are offering the same conditions and are running at the same time and as a consequence, the brokers could perform or deliver the best possible execution for their clients.

So it's important to use one specific standard. Here the CVM proposed that this standard should be the UTC, that is currently the standard used by the B3 and we also think that the Securities Commission should impose minimum requirements in terms of precision in the currency to be adopted by all the players in the markets. So this is one important point. Although the hearing does not touch on operational aspects on how to implement that, definitely this is a topic that should be discussed with all the market participants to find the best possible way to implement that in terms of costs and in terms of time frame.

The second part is related to data consolidator. There is a discussion if we should or not should have single official data consolidator in Brazil, as you have in US, for example. Here the proposal of the Securities Commission is that we should not have one single player offering the services. Actually, it should be a more competitive dynamic with multiple players providing these kind of services. We agree with the view of the Securities Commission and here our only comments to them is that, they should define or impose minimal requirements that should be followed and matched by the companies or entities that are willing to offer this kind of data consolidator services.

The third topic has to do with listing requirements and admission of the securities to be traded in the venues. Here for equity especially, it's current practice that not all the securities should be admitted to actually be traded, but also the issuer of that securities should be listed and follow a specific set of rules in terms of disclosure, governance and so on so forth. And this is a practice for the equities market, but we don't believe that it should be a minimal requirement for other kind of securities, for example, bonds and other kind of securitization and debt instruments.

In this case, requirements for the issuer are much lighter and we are worried here that if the same kind of scrutiny and requirements are imposed to them, it could have a negative impact in the fixed income, in the development of the corporate fixed income market in Brazil. So we should have different set of rules for equity versus other kind of securities end markets.

The fourth topic has to do with risk management and internal controls that should be adopted by each trading venue that is operating in Brazil. Here, we believe that is a very important to set minimal requirements for everyone to make sure that we will not have any kind of deterioration of the quality of our markets. And also, it's important to avoid any kind of arbitrage in terms of rules and requirements between different venues offering advantage or disadvantages to different group of players.

The fifth topic has to do with procedures that will ensure that if a specific security is suspend or excluded off the trading section, this should happen at the same time with synchronicity between all the venues. This should not be best efforts, actually it should be some kind of arrangement or procedure or IT mechanism that make sure that this rule, or this specific suspension, will happen at the same time among all the vendors. So there are many technical discussions here, but we believe that considering the level of latency and the trading that exists today in Brazil, it should not be any kind of analogic or time consuming process that will lengthen [ph] establish communication among the venues. It should be some automatic procedure that will connect and ensure that it will happen at the same time among all the players.

Moving to Slide Number 5, there is one of the key topics of this hearing that has to do with the proposal brought by the Securities Commissions to add some kind of flexibilization and innovation in the Brazilian regulatory framework in regarding to block trading. So in Brazil, as you know, the same set of rules apply for regular transactions with average size and at the same time applies on large block transactions.

So what the Securities Commission is bringing to the table is the possibility of having new special procedures or new special segments that would facilitate and improve the environment or the platforms to enhance the matching of block trade orders. So here, our main highlight has to do with how this kind of flexibility could jeopardize or negatively impact the integrity and the transparency of the markets.

One or two of the possibilities that could be allowed would be no pre-traded transparency for these kind of transactions and also they not necessarily should follow the time and price priority that we see in the order book that is very common in all the exchange around the world. So if the Securities Commission allows that any kind of blocks should not follow this minimum requirements or rules, we believe that over time, it could have a very negative impact in the price discovering process in Brazil, and as a consequence in the quality and in the integrity of our markets.

That's why we are proposing to the Securities Commission that they should cap or establish a cap in terms of volume traded, in regard to the group or the share of the transactions that could follow this more flexible rules.

We are setting the threshold at 15%. So in other words, 85% should be -- 85% of the volumes should stay at the club, at the lead market with full transparency and also respecting the time/price priority rules that are applied in the order book.

The Securities Commission also asked if this special set of rules for blocks should be implemented within an exchange environment or within what we call here in Brazil, organized OTC, that is a OTC that need to follow a minimum set of rules set by the Securities Commission. And in our view, it's clear that an exchange environment offers advantage over OTC platforms. First, because it's centrality that allows any intermediary and any investor to access the platform or to access the order flow on their equitable conditions, increase significantly the chance of the sale and the buy order match each other within the platform. This is very common in all the exchanges around the world. There are innovations that implemented in Europe and in other jurisdictions that facilitates the trading or the matching of blocks within an exchange environment.

Also, the entire infrastructure, procedures, technology, it's already in place in Brazil for the exchange environment. So it should have a much smaller operational and cost impact for the entire industry in Brazil and in other words, it should be the short way to improve the trading of blocks in Brazil.

And finally, there are some -- two very important aspects related to tax treatment and legal or other kind of restrictions that would apply in different group of clients. For example, foreign investors, when they trade within an exchange environment, they are exempted of capital gain tax. It is not true if this transaction is carried out in an OTC platform. So foreign investors would be in a bad position to trade blocks versus local transactors. But also, we have restriction that applies on specific group of institutional -- local institutional investors, notably pension schemes in Brazil, that impede then to trade securities or stocks in an OTC environment. So allowing block trading on OTC platform without addressing these restrictions could create distortions that will impede or disbalance the equilibrium or the level-playing field among all group of clients that are very active in the Brazilian markets. So that's why we believe it should happen, this flexibility should be added to the exchange environment. Obviously, B3, but also other potential exchanges that are willing to open operations in our markets.

And finally, probably the most important aspect here is the fact that, once you are trading in exchange, you have the guarantee of a central counterparty for all the transactions. Trading OTC, according to the Securities Commission, could be possible in a bilateral settlement arrangements that will change completely the risk assessments made by all the clients, will change completely the risk assessment dynamic and potentially bring risks that are not present in our markets today.

And finally, one very specific aspect of this discussion is that, the Securities Commission have not set what is the threshold that says or that sets, what is a block and what is not a block. They believe -- they are proposing that the SRO entity should be the one responsible for setting these thresholds. And we will discuss the rule of the SRO in the coming slides and we don't think this should be responsibility imposed to this player or to this entity. Actually, it should be a responsibility of the Securities Commission after discussing with different group of market participants, including investors and intermediaries, what should be the best threshold of considering different levels of liquidity, different levels of market cap and obviously, any potential impact in the integrity of the Brazilian markets.

Moving to Slide number 6, we have some comments on the Draft B that covers the roll-off SRO in the Brazilian markets. Today, the regulation says that each exchange should have its own self-regulatory entity or self-regulatory department. In the case of B3, we own one specific company that is not for profit called BSM that provides these services for B3 in all the organized markets that we have within our Company. The discussion brought by the Securities Commission touches on the possibility of having one single SRO for the entire markets, offering services for all venues that are operating in our markets.

We agree with this concept, that's why we have any kind of restriction to impede BSM to offer services for new entrants or new exchanges, but we don't believe that this should be in position or a requirement set by the rules. Actually, it should be a choice of the new exchange or of the new entrants if they want to build or develop its own SRO structure or if they want to hire the services provided by BSM.

So under economy and -- as economic [ph] conditions that on one hand does not create any kind of barrier for a new entrant and on the other hand does not create any kind of free-riding effect or advantage for the new player versus the incumbents. So the hiring of these services should happen through a commercial agreement and we believe that the Securities Commission should describe in the rule which kind of criteria or methodologies should be adopted by the SRO to evaluate the price its services.

The third topic here has to do with the competences of the SRO. As I mentioned, this hearing is proposing a very relevant change in the dynamic of the market in Brazil and it definitely will impact the role of the SRO. And we don't think that this is the appropriate time to also adding new responsibilities and also expanding the competences of the SRO. For example, having the responsibility to set what is the threshold for blocks or not.

We believe that, it should not happen at the same time. We first need to wait to see how the Brazilian market will develop. If we will or not have new players in the Brazilian market, specifically new exchange and then, over time discussing if it is the case or not to add the new responsibility to the SRO.

Finally, in this slide there is a discussion regarding the investor compensation mechanism that we call, MRP. Before going details in this topic, it is important to make sure that you are aware that this discussion has nothing to do with the CCP rule, or with the safeguards or guarantees that are pledged in the CCP and as a consequence offers safety and integrity to the markets. This is a different discussion.

Here, the MRP, it's a mechanism or a fund created over the past decades in the Brazilian market and it offers some kind off safety to retail investors. In cases where, for example, the brokerage house that's used by these investors, bankruptcy or in case of loss of the investor as a consequence of operational mistakes or wrongdoings of the intermediary, the investors can claim to be compensated or reimbursed by this fund. This is a fund that today amounts to BRL380 million as a total and the cap for reimbursement is BRL120,000, that's why this mechanism address specifically retail investors, not institutional investors.

Here, the discussion is that whilst the Securities Commission believes that this MRP mechanism should be open to the entire markets, B3 believes that these was built specifically to cover or to protect investors that are trading within B3's platforms or within B3's venues. So if a new entrant or a new exchange want to set up an operation in Brazil, they should first built its own MRP mechanism or asking B3 and BSM to access the existing MRP and paying for that. And that this discussion should be a traditional commercial discussion between the new entrant, BSM and B3.

Finally, moving to Slide number 7, we have some comments on the Draft C, that covers best execution criteria in the Brazilian markets. In fact, we already have a rule that covers this subject, that is the CVM Rule 505, but considering, we only have one exchange in Brazil, it's not a topic that's being frequently discussed with the markets, but in a potential fragmentation of the Brazilian market, this criteria or these rules definitely will gain relevance.

And here, in our view, first, the existing rules under CVM Rule 505 is already prepared and well-designed to address any kind of problem that would be created by the fragmentation. It clearly sets responsibility for the brokerage firm to agree with its clients what means best execution for each of them or for each group of clients and as a consequence, they would be, therefore, obliged to follow these requirements and this criterias.

The CVM also raised some questions if we should have are not OPR rule in Brazil following the framework, you have in the US markets. We don't believe that this is the case. Bear in mind that the market works very efficiently in Europe without OPR and also in other jurisdictions. And also considering that the OPR rule is being under a lot of criticizing from many players in the US markets and the OPR rule itself is being under the scrutiny of the regulators today. So we don't think it would make sense to implement this kind of arrangement in Brazil and as a consequence, without a OPR rule, the CVM would not need to oblige each brokerage firms to be connected to all the venues. So this is a key topic for the intermediaries industry in Brazil. Obliging them to connect to all trading venues would potentially increase significantly the costs and the investments that are necessary to maintain all this complex infrastructure.

Regarding to the differentiation between qualified investors and non-qualified investors, notably retail investors, the Securities Commission is proposing that retail investors should follow or the orders of retail Investors should follow very specific and strict set of rules based exclusively on the total disbursements in that transaction.

So what it means, if a retail investor sent order to a broker, the broker needs to choose if they will execute that order in the Exchange A our in Exchange B, and this decision will be made considering exclusively the total cost of that transaction, including not only the fees charged by the exchange, but also the spreads, the bid and ask spreads in the screen at that specific moment.

So although it apparently makes a lot of sense considering that retail investors are usually not that informed, it could create some distortions, specifically for retail investors that are more sophisticated and that, as a consequence, would prefer to execute their orders in a venue that offers low latency, better technology, better services in a venue that offer discounted schemes for example, and finally, for the ones that are trading more intensively. Concentrating the order flow and the transactions within one single CCP is definitely much more efficient than fragmenting that among different CCPs and different platforms.

So that said, we think the Securities Commission should not bring such a strict rule for retail investors. Actually, they should offer to retail investors the same treatment that are offered to institutional investors, where the broker can design the best execution criteria considering the profile of each client.

And the last topic of these slide and end of this presentation has to do with rebates and pay-for-order-flow schemes that are allowed in some jurisdictions and are not allowed in other jurisdictions. Considering what we learned from -- what's happening in other developed markets, we think that allowing these kind of schemes could create distortions in the Brazilian market and could distort the best execution rules that not necessarily will be in the best interest off investors in Brazil. So exchange and other trading venue should not be allowed to offer any kind of rebates or pay-for-order-flow schemes to attract order flow to their platforms.

So I conclude here the presentation, so we can turn to the Q&A section.

Questions And Answers

Operator

Thank you. (Operator Instructions) This concludes today's question-and-answer session and concludes the B3 audio conference for today. Thank you very much for your participation. Have a good afternoon and thank you for using Chorus Call.