



Mifid And Market Transparency: Issues and concerns

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INTRODUCTION



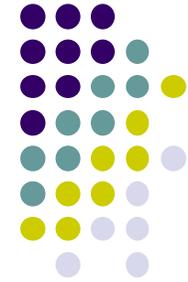
- ❖ The creation of a truly integrated, competitive financial market is necessary for monetary union in Europe to deliver its full potential. Bringing together national banking markets and developing a single capital market have been widely recognized as crucial to increase Europe's growth potential.
- ❖ Although the transformation of the financial market architecture in Europe started in late 1980s, it accelerated throughout the 1990s in preparation for the advent of monetary union. However, it was realized that monetary union would not create a single financial market by itself and earlier studies had identified remaining barriers to the creation of such a market. This led to the launch in 1999 of the Financial Services Action Plan (FSAP), a broad legislative and regulatory program that gave further momentum to financial integration in Europe. As a result, EU financial integration has progressed significantly, most notably in the provision of wholesale financial services.
- ❖ The Markets in Financial Instruments Directive (MiFID) is the centerpiece of the FSAP and a major step toward the creation of a single securities market in Europe. Although MiFID pursues the same ultimate objectives as the previous ISD, it sets up a more comprehensive and homogeneous regulatory framework, including an updated and expanded "passport system", in order to create a level playing field and eliminate remaining barriers to the provision of cross-border securities-related financial services.

A MULTI-LAYER REGULATORY EFFORT



- ❖ MiFID has the potential to significantly transform the provision of financial services and the functioning of capital markets, primarily equity markets, in Europe. MiFID relies on several complementary levers to foster increased integration of EU securities markets. These are:
 - **Competition.** The new framework injects new competition among financial intermediaries at each step of a security's transaction cycle, from the provision of investment advice to the practical execution and settlement of the transaction. A major feature of MiFID is to open the execution (and settlement) of equity transactions to a variety of operators, through competing trading venues.
 - **Best execution and transparency.** To balance the risks of opaqueness and liquidity dissipation stemming from a potentially more fragmented trading infrastructure, MiFID relies on increased transparency and information requirements for the benefit of the market, while best execution requirements will provide more systematic investor protection.
 - **Regulatory cooperation and supervisory convergence.** Increased cooperation among securities regulators, notably thorough convergence of supervisory practices, is essential for a homogeneous implementation of MiFID. This, in turn, is key to ensure that more contestability and competition lead to larger and deeper markets rather than more but less liquid ones.

MiFID'S MAIN OBJECTIVES 1



❖ **Fostering the emergence of a single, more competitive, cross-border securities market across the EU.**

- ❖ MiFID promotes, and often prescribes detailed rules, European-wide legislative harmonization for key components of the provision of financial services along three central principles: increased competition, including across borders, on a level playing field; increased market efficiency; and better investor protection. This combination is expected to encourage market intermediaries to offer and investors to demand more financial services as well as to increase participation in (and therefore liquidity of) financial markets. More specifically, MiFID opens competition between trading venues and broadens the use of the European passport for the provision of financial services across borders.

❖ **Fostering competition for order execution among different trading venues by abolishing the order concentration rule.**

- ❖ By abolishing the order concentration rule, traditionally been in place in various EU countries, MiFID requires that transactions be executed on a regulated market. While MiFID re-affirms the role played by regulated markets in listing securities and financial instruments, it authorizes two additional trading venues where orders can be executed in an organized manner: Multilateral Trading Facilities (MTFs) and “Systematic Internalizers” (SIs). MTFs are electronic platforms that facilitate the execution of trades by matching clients’ orders. SIs are firms that execute client orders by dealing on their own account outside a regulated market or a MTF on an organized, systematic and frequent basis.

❖ **Fostering cross-border provision of financial services and competition, by broadening the reach of the European passport.**

- ❖ MiFID could prove to be a catalyst for cross-border integration in these areas, contributing to faster de-segmentation of markets. Under the expanded passport framework, a firm licensed to provide financial services in its home country has the right to provide these same services on a broad range of financial instruments throughout EU countries, without the need for an additional license.

❖ **Fostering the provision of investment advice as a “passportable” activity and broadening the range of asset management activities.**

- ❖ To encourage investors to take advantage of the more level playing field, MiFID reinforces and harmonizes investor protection rules, in particular to the benefit of retail investors. Best execution is a key concept introduced by MiFID, and refers to a broader range of quantitative (price and fees) and qualitative (speed of execution, likelihood of execution and settlement) factors and requires market intermediaries to seek the best overall conditions, considering the characteristics (size, nature) of the order received.

MiFID'S MAIN OBJECTIVES 2



❖ **Fostering efficiency and competition by extending the principle of best execution to apply to all market intermediaries and all financial instruments.**

- ❖ Client categorization determines the obligations of financial services providers under MiFID, in particular with regard to the “suitability” and the “appropriateness” of the services provided, and forms of communication to clients. Most best execution requirements benefit retail and “professional” clients, but do not apply to so-called “eligible counterparties.” The obligation of best execution also applies to portfolio managers, including managers of private investment pools such as hedge funds. MiFID will provide a form of EU-wide regulatory harmonization, in particular regarding the provision of cross-border services. At the same time, investment firms distributing hedge funds will have to comply with MiFID’s investor protection rules, in particular when seeking retail investor business.

❖ **Increasing market transparency & investor protection by ensuring that competition between trading venues does not fragment market liquidity**

- ❖ Pre-trade transparency requirements (i.e., disclosure of current bid and offer prices, depth of trading interests at current prices, best bid and offer prices posted by market makers) apply to share transactions conducted on RMs, MTFs, or through SIs. They allow investors and other market participants to have a complete view of market conditions and to access trading venues where liquidity is superior. Combined with best execution obligations, pre-trade transparency is expected to ensure that increased competition between trading platforms does not result in liquidity fragmentation. Post-trade disclosure obligations require all market intermediaries to publish the details (i.e., price, volume, time) of share transactions they have undertaken. In fact, MiFID requires that transaction information be disclosed rapidly (“as far as possible in real time”) after the trade is completed. However, exceptions can be granted by national authorities for large trades and block trades.

❖ **Promoting a homogeneous EU-wide “rule book” for the provision of financial services w/o imposing an indiscriminate set of rules for all transactions.**

- ❖ MiFID covers a much broader set of financial instruments, and in particular derivative instruments, including “exotic” structures. The requirements of MiFID vary with the instruments traded, the platform on which they are traded, and the quality of the clients, resulting in a complex web of rules and multiple requirements imposed on market intermediaries.

❖ **MiFID’ transparency requirements do not apply (yet) to non-equity markets**

- ❖ Following a heated debate on transparency in fixed-income markets where “spontaneous” transparency is scarce, the EC decided, in the absence of obvious “market failures”, to not extend share transparency requirements to these markets. However, market developments and the recent crisis have changed EC’s stance and today transparency in fixed-income markets has come back on the agenda.

MARKETS AND TRANSPARENCY



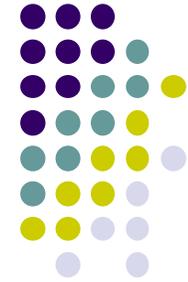
- ❖ Transparency in capital markets is a central issue in policy-making and academic research. Transparency directly impacts on price formation and thereby market efficiency. **There is no universal recipe for the "right" transparency.** Different markets and market segments require different solutions and both the type and amount of transparency affect market functioning.
- ❖ The overall purpose of capital markets is to contribute to the best possible allocation of economic capital. Well-functioning markets for purchase and sale of securities benefit the entire economy: business enterprises, investors, savings holders, homeowners, taxpayers, consumers, etc. Both investors and borrowers must be able to buy and sell securities at prices that reflect the relation between supply of and demand for capital. This requires well-functioning markets that are subject to competition and effective price formation. **Transparency must therefore be assessed on the basis of ensuring well-functioning markets.**
- ❖ Capital is predominantly allocated via the professional markets (the wholesale markets), in which the market players are securities dealers and institutional investors. This is where the funds relating to pension savings, home ownership, business enterprises, etc. are traded. **When the terms for transparency are determined, the requirements of the wholesale markets should, therefore, carry most weight.** The retail markets are of less significance to the total allocation of capital, although effective retail markets can be important for individual minor market participants. This e.g. applies to mortgage financing, typically the largest single item of households' budgets. It also applies to minor investors holding funds for placement.
- ❖ **Giving priority to wholesale markets does not conflict with ensuring the best possible transparency in retail markets.** A well-functioning wholesale market is prerequisite to a well-functioning retail market. Moreover, in many cases structural advances in wholesale markets will facilitate equivalent improvements in the design of retail markets.

TRANSPARENCY AND PRE / POST-TRADE INFORMATION



- ❖ **Pre-trade information.** It is market information accessible up to and at the time that a trade takes place. This is typically information on prices and order volumes available for sale or purchase in the market. Pre-trade information gives the market participants the opportunity to continuously observe the market's development and execute actual transactions at known prices and volumes. When assessing a market's functioning, it is therefore important to consider the scope and quality of the available pre-trade information.
- ❖ **Post-trade information.** It is market information, available after the time at which a trade has taken place, and includes individual trades, or aggregated information on each dealer's or a market's total activity in a given period. Information on individual trades may include price, volume, time and buyer/seller identity. Reporting requirements serve several purposes:
 - **(a) Meet the need for external market supervision.** For market supervision it is necessary to have access to information on individual transactions. This is the only way that a regulator can conduct ongoing market supervision and investigate cases of market abuse. To this end, it is best that transactions are reported as quickly as possible. It is important to distinguish between the need for internal reporting and the need for public disclosure of reporting. Effective market supervision does not depend on trades being made public.
 - **(b) Meet the needs of market self-monitoring.** The market itself exercises market discipline, i.e. by the market participants with a direct interest in compliance with the market rules.
 - **(c) Provide market participants the opportunity to check whether settlement takes place at right prices.** Post-trade info will always be recent or older historical data. The longer the reporting and/or disclosure lag, and the stronger the price volatility in the market, the greater the uncertainty as to whether the post-trade information reflects actual trading prices. The need for transparency does not always mean that every trade must be made public.

MARKET INFORMATION, TRANSPARENCY & LIQUIDITY



❖ Market information and transparency

- A given type of market information may affect transparency in different ways, depending on the market. For example, immediate publication of completed trades will increase transparency in a telephone-based market where updated pre-trade information on best bid and offer prices are not immediately available from one central source. The same may apply to floor-trading markets in which the dealers physically signal bid and offer prices to each other. On the other hand, disclosure of completed trades will not really increase transparency in an electronic market with access to pre-trade information on current bid and offer prices. Therefore, in order to change the transparency of a market it is important to consider the actual market .

❖ Significance of the degree of transparency

- Not only the type, but also the degree of transparency affects the functioning of markets. While transparency is prerequisite to well-functioning price discovery it may also be appropriate, depending on the market, to limit certain categories of market information, typically the rapid publication of post-trade information on individual trades. In some cases certain types of pre-trade information might also negatively affect liquidity.

❖ Different markets require different solutions for transparency

- Pre-trade information of high quality will optimize market participants' opportunities to execute trades at known prices and volumes. Pre-trade information of high quality will e.g. be available in electronic trading systems that include mandatory price quotation schemes. Markets in which large, liquid, standardized products are traded, either government securities or major share issues, can support such schemes. On the other hand, in markets in which smaller, illiquid products are traded, typically minor share issues, it would not be necessary to establish access to ongoing pre-trade information of high quality. In these markets it would typically not be possible to establish a commercial basis for the introduction of electronic trading. Moreover, market makers would require prohibitively high payment for taking on the risks related to an obligation to quote prices on an ongoing basis in an illiquid product. Between these two extremes there is naturally a large group of products in which it would be possible to establish various types of pre-trade information to a greater or smaller extent.

MiFID'S APPROACH TO TRANSPARENCY 1



❖ Overall approach to transparency

- Within the EU, the issue of transparency has played a major role in FSAP. The type of transparency that relates directly to the trading situation is regulated by the MiFID: **Art. 27** refers to obligations of systematic internalizers to make public firm quotes, **Art. 28** refers to post-trade disclosure by investment firms, **Art. 29** refers to pre-trade transparency for MTFs, **Art. 30** refers to post-trade transparency for MTFs, **Art. 44** refers to pre-trade transparency for exchanges, **Art. 45** refers to post-trade transparency for exchanges, plus **Recitals 44 and 46**.
- As mentioned, **no "one size that fits all"** for transparency in the market. Type and degree of transparency must be adapted to each market. To a large extent MiFID take this into account.
- MiFID is solely concerned with transparency of **share markets**. However, the member states may decide individually to apply provisions to **other financial instruments** (See Art. 65(1), as amended by Dir 2006/31). According to MiFID, the right form and degree of transparency would contribute both to protecting investors and ensuring efficient securities markets. MiFID sets transparency as a necessary precondition for competition, and thereby the ongoing integration of the EU share markets. **Investors must at all times be able to compare the prices of the products offered, including prices for the same product traded on different markets.**
- MiFID perceives transparency as an important **element of ensuring Best Execution**. Investors must be able to monitor the conditions in which their trades are executed, including settlement at the right price. MiFID's approach is to ensure the **same degree of transparency regardless of whether shares are traded in regulated markets, in MTFs, or outside these systems**. MiFID thus sets out transparency requirements in connection with investment firms' internalization, i.e. when investment firms systematically execute client orders by dealing on own account.

MiFID'S APPROACH TO TRANSPARENCY 2



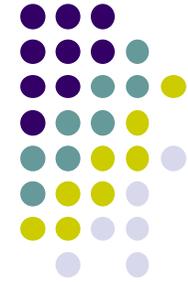
❖ Provisions on Pre-trade transparency

- Pre-trade transparency rules have been harmonized between RE and MTF, while SI have been provided with slightly different provisions resulting in less stringent requirements. MiFID requires individual M-S to ensure that RE and investment firms operating an MTF in their respective markets make public pre-trade information, comprising current **bid** and **offer prices** as well as the **depth** of trading interests at those prices. This information must be available to the general public on what is deemed a **reasonable commercial basis**. M-S **may exempt markets or market segments wholly or partly from the obligation to ensure the disclosure of pre-trade information**. It is the case either when the market model or the type of order does not require pre-trade information to be disclosed or for orders considered large in scale compared to normal market size.

TYPE OF TRADING SYSTEM	INFORMATION TO BE MADE PUBLIC
Continuous auction order book	5 best bid / ask prices, # of aggregate orders at each level, aggregate depth (shares) at each level
Quote driven system	Best bid and ask prices for each market maker, depth at each price
Periodic auction system	Theoretical equilibrium price with traded volume at that Price
Other systems	Broadly similar requirements

- Following intense lobbying from various industry participants, pre-trade transparency requirements were defined differently for SI. Specifically, the obligation is lighter as it only applies when they trade shares admitted to trading on a regulated market for which a liquid market exists and for sizes up to standard market size. Within this context, we need to define “a liquid market” and “standard market size” for the purpose of this Directive (see later). Under MiFID, investment firms internalizing only orders above the SMS or dealing in non-liquid equities will consequently not be expected to publish their quotes.

MiFID'S APPROACH TO TRANSPARENCY 2



❖ Provisions on Post-trade transparency

- **Reporting to the competent authority.** All transactions — whatever the financial instrument or the trade execution venue (RM, MTF, SI) – must be properly reported to the CA so as to allow it to proceed with any investigation required to ensure that IF “*act honestly, fairly and professionally and in a manner that promotes the integrity of the market*” (Art. 25). Accordingly, IFs which execute transactions in any financial instrument admitted to trading on a RM will have to: (a) report transactions details to the CA as quickly as possible, and no later than the close of the following working day; (b) maintain records of all transactions for at least 5 years and keep them at the disposal of the CA; and (c) make information available both to the host MS and home MS, unless the home MS explicitly requires this information not to be transmitted.
- **Public reporting to market participants (equities only).** MiFID harmonizes post-trade transparency for RE, MTF and SI. Whatever the execution venue, there is an obligation to publish all trades as close to real-time as possible **and at least within 3 minutes of the trade occurring**. For **each transaction**, the following must be made public: (a) execution venue identification, (b) instrument identification, (c) date and time of the trade, (d) quantity and price per share. Delayed publication may be allowed by M-S if justified by scale and nature of transactions (i.e large trades).
- MiFID is not prescriptive on how the information should be made available but stipulates that **information** could be disclosed: (a) through the facilities of any RM which has admitted the instrument in question to trading or through the facilities of an MTF in which the share in question is traded; (b) through the office of a third party; and (c) through proprietary arrangements.
- L2 Regulation further clarifies that disclosure arrangement must satisfy the following: (a) it must include all reasonable steps necessary to ensure that disclosed information is reliable, monitored continuously for errors and corrected as soon as errors are detected; (b) it must facilitate the consolidation of the data with similar data from other sources; and (c) it must disclose information on a non-discretionary commercial basis at a reasonable cost.

MIFID'S APPROACH TO TRANSPARENCY 3



❖ The List of Liquid Shares I

- MiFID's treatment of liquidity involves various issues: (a) the impact of unexecuted limit orders on market transparency, (b) the challenge of standard formats for trade data feeds, and (c) the list of liquid shares. This presentation focuses on one critical aspect: *the formation of the **List of Liquid Shares***. In order to level the field for market participants across Europe, CESR has to first create a solid pan-European equity foundation; a baseline from which to measure all other all equity activity. This benchmark is the **Liquid List** using (i) individual stocks' market capitalization, (ii) turnover and (iii) numbers of trades per day to form an **Average Value per Transaction (AVT)**. Then other shares may be comparitively judged and selected for inclusion in the List.
- The Liquid List will be created by first taking all shares from each of the 29 M-S and establishing if they are '*liquid*' as defined by Art. 22 of the L2 Reg. The process requires formulaic scrutiny and information being made available by the Primary Listing venue of each stock. However, the analysis across all EU equities shows that some M-S do not have any shares that satisfy the requirements of a liquid market. Once the shares have gone through the formula it is then dispatched into a **Standard Market Size (SMS)** classification, as outlined below.

Average value of transactions (AVT in €)	AVT < 10.000	10.000 ≤ AVT < 20.000	20.000 ≤ AVT < 30.000	30.000 ≤ AVT < 40.000	40.000 ≤ AVT < 50.000	50.000 ≤ AVT < 70.000	70.000 ≤ AVT < 90.000	Etc.
Standard Market Size (€)	7,500	15,000	25,000	35,000	45,000	60,000	80,000	Etc.

- This table **has no upper limit** and so where shares have an AVT > €90,000 a new classification can be created and shares allocated to the relevant SMS. Also as regards the Liquid List some shares will be below the minimum SMS of €7,500 and at this point they are considered to have an SMS equal to RMS (retail size), as def by Art. 26.
- This will be the case for many of the illiquid shares and when compiling the List it is likely that many newer and smaller RMs will carry primary Listings of such shares. In order for CESR to form the Liquid List all CAs will have to publish the following data on the first trading day of March: *“(a) the average daily turnover and average daily number of transactions, as calculated in accordance with Art. 33(1) and (2); (b) the free float and average value of the orders executed, where calculated in accordance with Art. 33(1) and (2).”* (Art. 34, § 1)

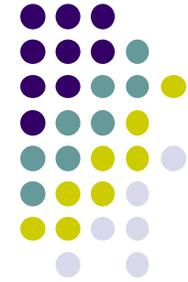
MIFID'S APPROACH TO TRANSPARENCY 4



❖ The List of Liquid Shares II

- Then, CESR will publish (Art. 34, §5) *“(a) every systematic internalize in respect of a share admitted to trading on a regulated market;(b) every share admitted to trading on a regulated market, specifying: (i) the average daily turnover, average daily number of transactions and, for those shares which satisfy the conditions laid down in Art. 22(1)(a) or (b) (as applicable), the free float; (ii) in the case of a liquid share, the average value of the orders executed and the standard market size for that share; (iii) in the case of a liquid share which has been designated as an additional liquid share in accordance with Art. 22(3), the name of the CA that so designated it; and (iv) the relevant competent auth.”*
- This **Liquid List** is then used as the **benchmark for transparency reporting** and for determining **when a share is liquid or not**. MiFID (and CESR) does not make it clear whether this List is, or will be, an index and whether it will form the basis for trading analysis in Europe but it is likely that people may look at it that way.
- MiFID does comment on the likelihood of modifications to the List during the year, outside of the annual publication dates, and so there is every possibility that, like the FTSE indices, the Pan-European 500 (or so) may become a benchmark for European equities. Art. 22 (6) states: *“Each competent authority shall ensure the maintenance and publication of a List of all liquid shares for which it is the relevant competent authority. It shall ensure that the List is current by reviewing it at least annually. The List shall be made available to the CESR. It shall be considered as published when it is published by the CESR in accordance with Art. 34(5).”*
- Moreover, Art. 33(5) says: *“During the course of a calendar year, the relevant competent authorities shall ensure the review and where necessary the recalculation of the average daily turnover, average value of the orders executed, average daily number of transactions executed and the free float whenever there is a change in relation to the share or the issuer which significantly affects the previous calculations on an ongoing basis”,* and Art. 34(4) adds: *“However, the classification based on the recalculations specified in Art. 33(5) shall apply from the date of publication and, unless further recalculated under Art. 33(5), until the following 31 March”*.
- MiFID text indicate that the List may change during the year if the CA so desires. As a result more shares could leave the List than join it if economic conditions were poor for the year, or equally more shares could join than leave as relevant economic indicators improve. To formulate the Liquid Share Market according to the well-defined criteria, proper information must be obtained ahead of publication by all 29 CAs.

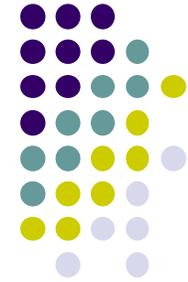
MIFID'S APPROACH TO TRANSPARENCY 5



❖ Liquid Shares and Extremities

- Once the data is gathered and examined in detail some very interesting results can be outlined. The Liquid List, by its nature should be the group of most liquid shares across Europe but in fact, after this first assessment, 2 areas stand out as being very far from that. **(a) There are about 13 of the 29 M-S exchanges which are likely to have the minimum entitlement of 5 stocks present because all stocks in their market are rarely traded** (often less than 100 times per day). Compare LSE that has 141 stocks (25% of the total) each on average with about 10 or 100 times the market cap of those stocks of say Tallinn, Riga or Ljubljana who have AVT far less than retail market share. This makes about 12% of the List appear extremely illiquid. **(b) At the other end of the scale, it is noticeable that 5 stocks stand out as having inordinately high SMS compared with the next series.** Again, some smaller exchanges don't have any stocks that, without the option of a minimum quota, would have ordinarily appeared on the Liquid List. However, after calculation, some of the small exchanges are seen to have the highest AVTs of any stocks on the entire List. Thus, both turnover and market cap of such stocks are much less than that of a big exchange stocks and so one has to ask how liquid these stocks really are.
- The reason for this apparent inconsistency is likely to be **tax efficiency or some other smart policy outcome.** It appears that the Pan-European Liquid List is to be put together on a geographic and political basis. It has a basic calculation that is used to determine the entrants to the List but two very important aspects that reduce the actual liquidity are that **(a) a country is entitled to a minimum of 5 stocks** and **(b) there is no upper limit for SMS.** As a result the extremities of the List are always open to question and the ability to judge economic growth using this List becomes less reliable. It may be that the List is not intended for such use and its sole remit is to increase transparency.

MiFID'S APPROACH TO TRANSPARENCY 6



❖ Liquid Shares and Dark Pools I

- CESR has stated that its main aim is to open up the market competition, to generate greater harmony across the EU, to break down national barriers and build economic growth. It also wants to reduce anti-competitive behavior and demonstrate a willingness to expose the darker areas of liquidity to regulatory scrutiny. It is likely that MiFID will succeed in generating greater competition; the **question still remains over how successful MiFID will be in exposing dark pools to the light of transparency.**
- Currently approximately **50% of equity trading is carried out in so called “dark pools”**. These are generally automated crossing systems run by large internalizers that match buyers and sellers without the order flow being exposed to the market. Once the order has been matched the buy and sell notifications are sent to an Exchange. The **reason for internalization is to reduce the cost of execution as well as preserve some anonymity pre-trade, but at the expense of market reliability and confidence.**
- Today, trading of even major large caps at quite small order sizes can be performed in dark pools (like Continuous Pools and Static Pools etc) by automated crossing systems, off-order book and off-exchange. **This can affect price formation of some quite liquid stocks.** Moreover, quote driven systems allow Market Makers, with their informational advantage, to widen spreads hiding a stocks true value, and leading to a false view of the market.
- The MiFID **pre-trade transparency obligations aim to remove such informational advantages and reduce the potential for dark pools.** Where before it was possible to lose transparency at quite low bargain sizes, post MiFID all major EU indices are now subjected to transparency requirements.
- National shares are distributed according to their AVT, demonstrating the increase in transparency. Within the ‘Transparent Liquid Market’ and below SMS, pre and post trade transparency will be delivered. As a result the likelihood is that **these stocks will appear in pan-European venues** (Equiduct, Turquoise and Virt-x) and it follows that **those venues which offer best execution in these stocks will appear on the execution venue Lists of banks, brokers, fund managers and dealers.**

MIFID'S APPROACH TO TRANSPARENCY 7



❖ Liquid Shares and Dark Pools II

- However, far from simply increasing transparency, in some instances **the formation of the Liquid List will actually decrease the SMS at which pre-trade data has to be published.** This means that some stocks will end up with an SMS that is lower than the current average bargain size and so could lead to a reduction in transparency in certain shares.
- In addition, **outside the Liquid List block trades, bilateral negotiations and dark pools will prevail and as technology advances this is likely to get worse not better.** The market is making more and more use of algorithmic trading and companies such as Instinet (with its Nighthawk algorithm) and JP Morgan with Aqua and Arid aim to help clients sweep dark areas of liquidity.
- Even more interesting is that the UK FSA (see CP06/14 paper) admits that, notwithstanding the benefits, increased pre-trade transparency may not be as desirable as one would think: *“Increased pre-trade transparency may reduce informed traders’ ability to profit from their informational advantage. This may reduce incentives for information gathering and reduce the information contained in prices. For example, market makers may be seen as informed traders when they compete for order flows so that they can gain from the information contained in these orders. The increase in pre-trade transparency lowers the informational value of these order flows as it makes them available to all traders, thereby reducing the incentives for market makers to post competitive bid-ask spreads. This may lead to a widening of spreads. A second negative impact may arise as a result of increased pre-trade transparency. Liquidity providers such as market makers – by offering public hittable quotes at a certain price – are effectively offering a free option to other market participants to trade at that price. There will be some cost to market markers of offering this option which may result in a decrease in their willingness to provide liquidity.”*
- Ultimately, of course, regulation is likely to catch up and **those venues (especially the newer fleet of MTFs) that remain flexible and competitive are likely to benefit significantly** as market transparency is extended.

MIFID'S APPROACH TO TRANSPARENCY 8



❖ Liquid Shares and Competition

- Whilst it may appear that the Liquid Market **will not necessarily reduce the dark pools of liquidity**, it is likely that it will absolutely **increase competition among shares** included in the Liquid List. Firms should want and need to trade in those major indices that will gain exposure on the List as they offer significant liquidity and clearer risk quantification. Therefore there is a need, especially with portfolio managers to trade in the Liquid Market and those brokers or fund managers that do so will need to deliver Best Execution to their retail and professional clients. This is possible (in sizes at or below SMS) **only where they have a selection of execution venues who offer execution choice in the quoted stocks**. Choice is more than just price: it is speed of execution, availability of execution styles, cost of clearing and settlement and of course spread.
- Therefore, it follows that **those trading venues who offer trading in the Pan-European Liquid List are likely to be on the execution venue List of the major brokers and banks**. It also follows that those values which are able to offer **low latency** – facilitating algorithmic trading and highly transparent markets – are likely to be most successful. The key question is whether market data, especially in a hybrid model (i.e. both continuous auction and quote driven), will properly inform market makers so as to keep spreads competitive and therefore attract order flow.
- This will not happen without the Liquid List. At present the incentive is to take trading off-exchange, avoiding exchange fees and trying to keep costs down by the use of automated systems. By increasing transparency, markets are able to adapt to new order flow and costs are reduced by the competitiveness of new trading venues. Already we are seeing existing venues reducing their fees ahead of MiFID and once a Pan-European List is available those **venues that are able to offer full price discovery across Europe with very high transaction speeds are likely to gain competitive edge and benefit considerably**.

MiFID'S APPROACH TO TRANSPARENCY 9



❖ Liquid Shares and Regional Exchanges I

- A significant question remains as regards the reaction of smaller regional exchanges located in countries with smaller GDP, such as the Czech Republic, Poland and Hungary, who have recently joined the EU and have illiquid equities markets compared to France, Germany, Italy and the UK. They are likely to have 5 stocks on the Liquid Market and for the first time, in many cases, **these stocks will suddenly be exposed to pan-European price formation**. This is a shock, when these markets are in some cases used to a trading frequency of less than 50 times per day.
- Despite the natural forces of competition, at the absence of MiFID, a significant barrier to entry would normally exist for such stocks, due to the presence of considerable cost of communication. **Currently the information regarding the 5 stocks available from the 13 countries that are entitled to the minimum is somewhat limited. This is because competition has not required the disclosure of such information outside those countries.** One only needs to examine the FTSE or the CAC index and it is immediately apparent that information on Vodafone or Total is abundant and as soon as anything happens that could affect the share price a public statement is made. But when examining stocks in, say, Lithuania considered as a domestic blue chips, little information exists other than that from the company itself and its auditors.
- The Liquid List is likely to change all that information. With market makers looking for new revenue streams in an ever tighter capital market, MiFID suddenly opens up the opportunities for business growth and therefore share price growth. Small MS banks that were once constrained by borders, are now unconstrained and have the opportunity to flex, create allegiances and potentially merge. New capital investment builds share price, liquidity and ultimately attractiveness. **The result will be a demand for information.**

MiFID'S APPROACH TO TRANSPARENCY 10



❖ Liquid Shares and Regional Exchanges II

- Nevertheless one significant challenge remains hidden. **Under the new regime, a share's liquidity is likely to increase but the concern is whether it will be traded in a reliable pan-European venue.** OMX (as an example) has been making significant strides to offer its technology to smaller execution venues but offering a full service across the Liquid Market coupled with the increase in demand from London or Paris based Market Makers seems a huge step for some of the small national RMs.
- In addition, the larger Pan-European RMs/MTFs (Equiduct, Virt-x and Turquoise) are likely to offer enriched services around the trading of the Liquid Market attracting business from the RM where the share was originally listed. As a result there is the **distinct possibility (national risk?) that shares from Lithuania, Slovenia or Poland will be traded more from say the UK (LSE), Belgium (Equiduct) or France (Euronext) than in their home state.** As this happens and the 5 shares admitted to trading on pan-European RMs increase in liquidity away from the primary listing venue the rest of the smaller market may suffer. Ultimately liquidity could drain away and the national exchange could be put under threat. This natural process of competition is exactly what MiFID is aimed at, but a **national exchange, in a political sense, is a source of pride and more importantly capital.** If the possibility of the exchange losing liquidity and eventually closing becomes real, it may force the EC either to re-consider allowing these economic forces to reach their ultimate conclusion or step in to provide some form of subsidy.
- Finally, if the national exchange of the smaller EU countries becomes threatened, other shares listed there will want to be admitted to trading on the more Liquid Markets to ensure they retain some capital exposure. This may **precipitate local de-listing** and raises two important concerns: **(a) the cost of being admitted to trading on the more Liquid Markets could be prohibitive, thus depriving small companies from enjoying the benefits of high liquidity, and (b) the smaller countries' regulatory standards may, in order to retain listed companies or attract new ones, be lowered relative to those currently expected in Paris, London, Frankfurt or Milan.** Both these factors could ultimately lead to an unbalanced market (in those stocks) and even the possibility of market abuse, the very thing CESR is so keen to avoid. 19

CONCLUSIONS



- ❖ While MiFID in itself allows scope for national authorities, in cooperation with market operators, to determine types and degrees of transparency, adapted to the individual markets, the actual market flexibility and the overall consequences for market transparency will depend to a very high degree on the market impact of the detailed implementing measures. Essential to the development of the European capital markets is the required political weighing of the necessary flexibility in determining transparency in individual markets against the need for a uniform basis for the ongoing integration of the European capital markets.
- ❖ A core element of MiFID transparency, the CESR Liquid List, is already increasing the attractiveness of European equities trading and new execution venues will demonstrate the MiFID vision of a truly pan-European market. These venues already see the tremendous value in being able to trade across borders, efficiently and with undisputed price formation.
- ❖ MiFID's value on a global context cannot be underestimated. It's aims are commendable and will benefit Europe in the long-run. MiFID has initiated most fascinating corporate manoeuvres in Europe. New RMs and MTFs (such as Equiduct, Chi-x and Turquoise) are vying to offer Best Execution in the Liquid Market and they're positioning themselves against the historic centerpieces of European trading, like the LSE and Deutsche Börse. The US has seen the huge potential: NYSE's merger with Euronext has gone ahead and NASDAQ's is constantly courting EU exchanges – and we may yet see others. Such corporate moves have a clear reason which is the prospective increased liquidity driven by European harmonization.

THANK YOU