London Investment Banking Association
ASSOSIM - Associazione Italiana Intermediari Mobiliari
British Bankers' Association
Bundesverband der Wertpapierfirmen an den deutschen Börsen
Danish Securities Dealers Association
Federation of Finnish Financial Services
Icelandic Financial Services Association
Norwegian Securities Dealers Association
Securities Industry and Financial Markets Association
Swedish Securities Dealers Association

CESR call for evidence on impact of MIFID on equity secondary markets functioning

The above 10 Associations provide CESR with the following joint response to its call for evidence. We welcome the opportunity to contribute to CESR's analysis of:

1. Trends in the markets since MIFID came into force, and the effects of those trends on market structure and competition.

2. The consequences of fragmentation for price formation and market efficiency.

3. Dark pools of liquidity and pre-trade transparency waivers in light pools of liquidity.

4. Categorisation of shares for pre- and post-trade transparency purposes, data quality and consolidation.

5. Attainment of the objectives of fostering competition and a level playing field between EEA trading venues, providing for efficient and orderly markets.

6. Policy implications.

It is important to stress that all conclusions, about benefits and costs of MIFID, are provisional at this stage. MIFID has been in force only a year. While it has had significant effects as described below, some changes resulting from MIFID implementation are still working their way through the system. Furthermore, it is hard in a period of market turmoil in some respects to disentangle MIFID effects from those attributable to changes in market conditions.

<u>CESR's questions</u>:

<u>Benefits</u>

1. What do you think are the key benefits for yourself or the market more generally that have arisen as a result of MIFID provisions relating to the equity secondary markets?

The removal of the concentration rule has made EU equity secondary markets more contestable. It has led to the development of more MTFs, including those trading pan-EU portfolios of shares, which has in turn provided a more flexible trading environment for market participants. It has promoted innovation in a range of areas as described under Q3 below. These developments have in turn led to increased competition, liquidity, and efficiency.

A number of new order types are now being utilised which have also led to improved liquidity and market efficiency.

Greater competition (and thus lower costs) among clearing and settlement venues is an important benefit, though there are offsetting effects of clearing and settlement fragmentation and the fact that many trading platforms control their own clearing and settlement venues (see below).

Competition has led to significant reductions of trading fees on some of the major trading venues, although others have not reduced their transaction fees significantly, and the reduction in trading fees has been partly offset by a decline in order sizes.

The formalisation of anonymous RM and MTF trading, and the introduction of new competition, has reduced market impact costs in some markets, although recent events have given new significance to the assessment of certainty of settlement.

The more consistent framework for market transparency across the EU, and greater choice of reporting venues, has also yielded cost savings and efficiency.

Implementation of MIFID led firms to undertake a systematic review of their execution capabilities. While MIFID requires all firms to grant best execution to their clients, it also enables specialized firms to help others to fulfil their obligations under MIFID by offering best execution related services. The pan-EEA approach to best execution should enhance the quality of execution in the market as a whole.

MIFID led to a rationalisation of regulatory obligations, enabling compliance to become more streamlined across the EEA.

2. Do you consider that there are any remaining barriers to a pan-European level playing field across trading venues? If so, please explain.

Some countries have not fully removed concentration rules, including Poland and Greece.

In Spain, the chief difficulty relates to the rules of the settlement system, Iberclear. There is a widespread belief that Spanish law and rules require trades entered into on MTFs to be reported to the exchange (Bolsa) in order to obtain the registration reference (RR) required for the buyer to take full ownership of equity securities. Although there are other solutions, these are seen to carry additional cost and operational risk. If the alternatives have not been fully explored, further contacts between MTFs and Iberclear may help to resolve this problem.

Some trading platforms own or control their own clearing and settlement venues, and use that ownership or control to limit or prevent competition at the trading level. The resulting obligation to use different clearers, lack of interoperability between CCPs in clearing, and different margin rules and requirements undermine the benefit of aggregation and netting when execution moves to a different venue which requires use of different clearer. This makes markets less efficient, because arbitrage opportunities are uneconomic. In order to gain the full benefits of competition at trading level, it will be necessary to resolve these difficulties at the clearing level.

3. Do you think that MIFID has supported innovation in the equity secondary markets? Please elaborate.

Yes. The implementation of MIFID has led to a large increase in the level of innovation in the equity secondary markets. MIFID has led to a proliferation of new MTFs and dark pools alongside RMs, providing more flexible, bespoke trading environments for market participants. The increase in innovation clearly has a cost associated with it, the time and resource required from business and technology in order to offer cutting edge smart order-routing, and the linkage of light and dark pools of liquidity has led to a significant technology spend over the last year.

MIFID has also led to a greater choice of trade reporting opportunities.

MIFID has led to the development of new independent software services that provide smart order-routing, linking light and dark pools of liquidity.

MIFID has also increased the opportunities for more competitive clearing, although the cost savings have been offset by the loss of efficiency as a result of trading venues being tied to particular CCPs, as described under Q2 above.

MIFID has forced firms to give thought to how they evidence the performance of OTC execution.

<u>Downsides</u>

4. Have you faced significant costs or any other disadvantages as a result of MIFID relating to equity secondary markets? If so, please elaborate. Have these been outweighed by benefits, or do you expect that to be the case in the long run? If so, please elaborate.

The implementation of MIFID-compliant systems, for example more sophisticated best execution functionality, has undoubtedly been costly for firms (initial and continuing costs, in particular IT costs relating to trade reporting and linkage to new venues , but also revision of internal policies and procedures, and monitoring of execution quality and review of policies, and response to client execution queries). These costs should however yield benefits for clients, and overall our view is that the costs of MIFID implementation have been outweighed by the benefits.

There are undoubtedly costs to firms in seeking liquidity in competing venues, and assembling available liquidity into understandable and executable form. Fragmentation of post-trade information makes it less easy or more costly to understand trading volumes in a timely fashion, and to undertake transaction cost analysis. It also increases the amount of capital that market participants have to use to support their trading activity. These additional costs have an offsetting effect on the cost savings referred to in our answer to Question 1. Services exist or are under development to counter some of these effects and make it easier to reaggregate data. It is important to allow these market developments to occur, and undertake a rounded assessment of cost savings as well as costs of more competitive markets, before seeking to draw conclusions about the overall effect of MIFID.

While MiFID has facilitated the establishment of new trading venues, it is also worth mentioning that in some cases MiFID had a rather limiting effect on the variety of market models which investors can choose from. In particular with respect to floor trading, the narrow focus on costs and speed of execution in the best execution provisions regarding retail orders did lead to a shift from [periodic] auction based trading models to more market-maker/specialist oriented pricing mechanisms.

See our comments under Q3 above on the loss of efficiency from multiple CCPs that offsets the benefits of more competitive clearing.

5. Have you seen/experienced any unexpected consequences in terms of the level playing field arising from the implementation of MIFID provisions relating to equity secondary markets? If so, please elaborate.

The greater competition in post-trade reporting has given rise to trade data from different sources. At present market users receive and interpret this data independently. The market has been slower to respond than expected to provide services to market users to enable them to receive trade data from different sources. Thus, while in some markets MIFID has provided market users with more easily accessible trade data than was available before, in other markets where trade reporting was previously more concentrated, it has become less easy to assemble a complete picture of the market. Transaction cost analysis and execution quality analysis is more difficult as a result. We understand that facilities are under development to recombine the data, and it will be important to assess the situation as these services develop. See also our comments on the clearing barriers above.

<u>Trading costs</u>

6. What impact do you consider that increased competition between equity trading venues is having on overall (i.e. implicit and explicit) trading costs? Please elaborate.

The overall downward trend of the cost of execution has continued with the increase in competition. The fall has been greatest where competition has been most intense, for example in the UK, Germany, and Nordic countries, although in some countries the fall is not so marked, and in some countries costs may have increased. Spreads have not widened as a result of MIFID. Spreads have fallen in particular for algorithmic trades, although spreads for block trades may not have narrowed significantly because of market volatility and price uncertainty. As noted above, whilst execution costs have reduced on certain trading venues, the combination of smaller average client order sizes and the increase in technology spend has meant that these savings are not as great as they might have been.

Although there are significant technology costs associated with linkage to new venues, and associated costs for linkage to their respective CCPs, tighter spreads in some cases and lower per-trade costs on some venues arising from increased competition are likely to have an offsetting effect.

Potential fragmentation

7. Do you think that there has been significant fragmentation of trading and/or liquidity in European equity markets? If so, please elaborate. Do you think that such fragmentation raises concerns (for example, does it impact on the price formation process, the overall efficiency of the markets, search costs, best execution requirements)? If so, please elaborate on these concerns.

There has of course always been "fragmentation" as a result of the parallel operation of on-exchange and OTC markets. Fragmentation of trading and liquidity in European equity markets has increased as a result of MIFID, although this effect has been concentrated in large capitalisation shares: fragmentation has not increased substantially for small- and medium capitalisation shares. MTF's and dark pools have gained significant market share over the last year

The position remains fluid. New entrants have gained significant market share, although the position of established regulated markets remains dominant. As it becomes technologically viable via order routers to trade securities actively across a number of execution venues, firms need to make arrangements to access new markets that they decide to include in their execution policies, and adapt their trading processes so that simultaneous trading across multiple venues can be controlled and managed.

Although as yet price formation has remained largely on-exchange, as venues proliferate, price formation has the potential to become more complex as new entrants' market share approaches that of traditional exchanges. Although price formation will remain on-exchange as long as key metrics such as the closing price remain significant for market participants and clients, it may in due course become necessary to consider what happens if MTF's market share should start to challenge incumbent exchanges as the most liquid market for specific securities, but reference prices remain on-exchange.

It may also be necessary to consider the effect on the ADT calculation of substantial fragmentation from the main market.

There are also implications for the calculation of average daily turnover where MTFs acquire significant market share.

Despite these considerations, our overall view is that the benefits of increased competition and liquidity outweigh any issues associated with fragmentation and post trade transparency. Furthermore, market solutions to the problems associated with data fragmentation should be given an opportunity to work before there is any consideration of a legislatively-driven European consolidated tape or order-routing system.

8. Do you think that MIFID pre- and post-trade transparency requirements adequately mitigate potential concerns arising from market fragmentation?

In general, yes, we consider that pre- and post-trade transparency requirements do mitigate potential concerns arising from market fragmentation. MIFID has deliberately promoted competition among trading venues (and therefore pre-trade information) and post-trade reporting. This approach was predicated on the market finding a means to reconsolidate data arising from different sources. As noted in our answer to Q5, the market has been slow to do so. However, the market in data is still settling down, and it is too early to say that a market solution cannot be found. A common symbology for MTFs would improve the transparency regime.

Transparency

9. Is the categorisation of shares appropriate in relation to: the definition of liquid shares, "standard market size", "orders large in scale", and "deferred publication"? If not, please elaborate.

The categorisation of shares was determined after long and complex negotiations. Firms have devoted considerable resource to adapting systems to take them into account. We are not aware of any particular new concerns about the definition of liquid shares, standard market size, or orders large in scale, and suggest that more time should be allowed before any decisions are made about changes to the requirements which would subject market participants to more system change. In particular, because of the recent decline in block trades, the orders large in scale regime is to an extent untested.

As noted in our answer to Q14 below, there have been concerns about the fact that firms have made use of the full MIFID delay period even when the whole risk has been unwound early in that period. Given that delays exist in order to protect clients from the impact of premature disclosure of a trading interest, there is no reason why firms should not report large trades immediately the risk has been offset. However, such matters should be dealt with via statements of good practice by the industry or regulators, not by attempting to reopen the categorisation of shares in the legislation. We do not believe that market participants are generally abusing their ability to delay the publication of trades to the full MIFID delay period even when the whole risk has been unwound early in that period.

10. Do you see any benefits (e.g. no market impact) to dark pools of liquidity (to be understood as trading platforms using MIFID pre-trade transparency waivers based either on the market model or on the type or size of orders)? If so, what are they?

11. Do you see any downsides to dark pools of liquidity (e.g. impacts on the informational content of light order books)? If so, what are they?

There are clear benefits in dark pools of liquidity, which are necessary: (1) for the market to provide for the needs of holders of large positions, and (2) for algorithms and smart routers to seek to gain price improvement and/or reduce market impact in dark pools throughout the lifetime of a smaller order or one which is split into smaller segments (an approach which is typically used in order to gain best execution).

Specifically, they enable firms to reduce the market impact of large client orders, thereby enabling clients to get better and fairer execution than would be available without them, and enabling firms to execute in size for them at close to the mid-price, rather than being forced to mask the client's position via algorithmic trading. Post-trade reporting provides rapid transparency on trades executed in dark pools. Clearly, there are certain costs associated with dark pools: technology costs associated with ensuring that trading systems offer smart order-routing and that light and dark pools of liquidity can be linked; different rules within each dark pool that must be reflected in firms' internal trading systems; or the cost of accessing different dark pools whose rules on such matters as order size and type differ. These costs are however intrinsic, and are outweighed by the likely benefits over time.

12. Do you consider the MIFID pre- and post-trade transparency regime is working effectively? If not, why not?

Broadly, yes, subject to the particular points we make in response to previous questions.

<u>Data</u>

13. What MIFID pre- and post-trade transparency data do you use, and for what purpose? Does the available data meet your needs and the needs of the market in general?

Our Members typically use a substantial volume of pre- and post- trade transparency data from various sources, primarily in order to ensure that they are offering clients optimal trade execution services.

There will always be improvements that can be made, primarily at present, as noted above, improvements to the arrangements for reaggregation of post trade transparency data, so that market users can obtain a better consolidated picture of trading across the EU, and better information about the number and types of transactions.

A further particular problem with data that members have identified is inaccuracies resulting from the delay in data vendors' list and data updates following changes in lists and data by CESR.

14. Do you think that MIFID pre- and post-trade transparency data is of sufficient quality? If not, please elaborate why and how you think it could be improved.

Some market participants have voiced concerns about the accuracy and accessibility, particularly of post-trade data. In particular, there have been concerns about the extent of double reporting, the use of MIFID delays (which in some case may have given the impression that trades were not reported, when in fact they were only delayed) and the posting of trades to obscure venues where the price information is less likely to be captured. These are valid concerns, although in some cases the position has improved as firms have got more used to the MIFID regime. There is a role for statements of good practice by the industry or regulators, for example to clarify who has the reporting obligation in complex circumstances, in order to minimise double-reporting of the same trade. Where firms are not acting in line with the spirit of MIFID, for example by deliberately reporting mainstream trades to obscure venues, that should be a matter for the local competent authorities.

15. Do you think there has been significant fragmentation of market data in the EEA equity markets? If so, please elaborate. Do you think that such fragmentation raises concerns (for example, does it impact on the price formation, the overall efficiency of the markets, search costs? If so, please elaborate on those concerns.

See our responses to the questions above on fragmentation and reconsolidation of sources of post-trade data. Fragmentation is a necessary corollary of competition, with lower costs in some respects associated with greater complexity and cost in others. It is also necessary to weigh the impact of market data fragmentation with other benefits and costs of more contestable MIFID markets and associated MIFID conduct of business requirements. At this stage the position in both trading services and trading data remains fluid, and the market continues to develop. It is thus too early to make a final assessment of benefits and costs. There have been calls for a European consolidated tape and order-routing requirements analogous to RegNMS in the US. We consider that it would be premature, at this early stage of MIFID implementation, to mandate a resolution of these concerns, which are better dealt with by market solutions. Furthermore, any developments in this direction would be complex and difficult in view of the existing differences in reporting formats and post-trade infrastructure.

16. Does the current availability of data facilitate best execution? If not, please elaborate.

Our Members' view is that the current availability of data is sufficient to allow them to facilitate best execution. It is important to recall that best execution is judged by reference to the trading venues which the firm judges it needs to access in order to be able to obtain, on a consistent basis, the best possible result. It is not an obligation to survey the market as a whole to obtain the best possible result for each trade. It is clear that in some circumstances it may be appropriate for a firm to conclude that the best result is available consistently on a single venue.

The data that need to be available are therefore commensurate with the firm's judgement of which venues it needs to be able to access. When a firm decides to link to a venue, it will access the necessary data. It is important to note that, pending the development of third party data reaggregators (and even then there will be a need to take account of the fact that data is useful only if the firm can act on it be executing) meaningful access (i.e. with the ability to trade quickly against relevant information) to multiple venues involves substantial system investment by firms.

17. Do you think that commercial forces provide effective consolidation of data? If not, please elaborate.

As discussed above, by definition, competition initially creates fragmentation of data by comparison with the pre-MIFID landscape. As also noted above, the response of commercial forces to the challenge of consolidation of data has been slower than expected, though we expect that commercial consolidation of data will increase. It is however, also necessary to take into account that, to be executable against, data must be accompanied by linkage to the relevant venue's trading facility.

<u>General</u>

18. Do you think that the implementation of MIFID is delivering the directive's objectives in relation to equity secondary markets (e.g. fostering competition and a level playing field between EEA trading venues, upholding the integrity and overall efficiency of the markets)? If not, why do you think those objectives have not been met?

The implementation of MIFID is delivering the Directive's objectives of fostering competition, as described above. MIFID imposes different obligations on different trading venues, reflecting differences in their role in the market and in the market risks that their operators take: in that sense, the playing field is deliberately different for different types of player. But within each category, subject to differences of implementation by particular Member State authorities, MIFID is delivering a more level market between Member States. As regards integrity and overall efficiency, there have been improvements in some areas, and deterioration in others, as described in our answers above. Competition and contestability have improved. Data have improved in some markets and deteriorated in others: in the latter case, developments are under way to remedy the situation. In some Member States, for example, MIFID standards are considerably higher than what existed before, in others, an efficient market has had to adjust in ways that will need time to stabilise in a new equilibrium. MIFID has allowed for different new business models to be created, based on the distinctions which are inherent in the legislation: this brings in turn its own challenges by requiring firms to develop a more sophisticated, in-depth and technical understanding of the market landscape.

Thus we consider that the implementation of MIFID is broadly delivering the directive's objectives. More time is needed to enable a full assessment. When the assessment is made, it needs to take account of all relevant factors. It is important to avoid the uncertainty that would result from piecemeal tinkering with the rules.

19. Do you see any other impact or consequence of MIFID on equity secondary markets functioning?

There may be a need to consider the implications of MIFID as regards dual or secondary listed equities, where the primary listing, and main price formation, is in a non-EEA jurisdiction.

The simplification of fee structures of exchanges has allowed better comparison of fees, to the benefit of retail customers as well as algorithmic trading.

We also observe that the cost of providing sophisticated brokerage systems under MIFID may act as a barrier to entry.

9th January 2009