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RESPONSE (3rd November 2008 - Ref.: CESR/08-872)

CESR CALL FOR EVIDENCE ON THE IMPACT OF MIFID ON SECONDARY MARKETS FUNCTIONING

I. Introduction and Executive Summary

The Federation of European Securities Exchanges (FESE) is a not-for-profit international association (AISBL) representing 42 Securities Exchanges (in equities, bonds, and derivatives) through 23 Full Members from all EU Member States and Iceland, Norway and Switzerland as well as 7 Corresponding Members from European emerging markets. MiFID is of great importance to all FESE members because it affects the **quality** of **our secondary markets** directly. We therefore greatly appreciate the initiative taken by CESR to assess the impact of the Directive in secondary markets so far.

General Remarks on the Scope of the Call for Evidence

As a general remark, we note that the issues tackled in the Call for Evidence are concentrated on the Markets part of MiFID and exclude subjects from the Intermediaries section. We believe that this approach may be too limited. As amply evidenced by the events of the last 1.5 years, the functioning of the secondary markets in Europe is directly affected by the actions taken by intermediaries. For instance, the conflicts of interest rules of MiFID, which are in any event quite limited, have a direct bearing on the performance of the newly established venues operated by investment firms. Yet, this topic is not covered by the Call for Evidence. Similarly, the only aspect of best execution raised in the Call for Evidence relates to the impact of fragmentation on best execution, whereas the outcome of best execution is also intrinsically linked to the way the intermediaries implement the rule.

We understand that for practical purposes CESR has created two separate sub-groups, with the Steering Committee in charge of the coordination. We urge CESR to ensure that the linkages between these subjects are addressed in the interest of investor protection. We have therefore included some remarks on subjects linked to intermediation where there is a direct link to the questions below. We trust that the results of this Call for Evidence be assessed by both sub-groups and the Steering Committee.

In summary:

- It is important to establish **causality** when assessing the impact of MiFID.
- One should not confuse the **objectives** (eg better terms for investors and issuers) of MiFID with the **means** (eg greater competition among venues)**.**
- MiFID has led to some new commercial activity and creativity, but its impact on **the quality of European secondary markets** is more mixed. There is not yet sufficient evidence to demonstrate that investors and issuers are benefitting from the commercial activity caused by MiFID in terms of better execution terms, higher liquidity or innovation.
- Certain problems are already evident with respect to **execution quality**, **transparency**, **neutrality**, and the **level playing field**.
- The Directive may be failing in particular in its aim of creating genuine competition among venues due to the lack of a level playing field among venues.
- The proliferation of **non-transparent and non-neutral** venues might be undermining both the price discovery process and the market integrity.
- Market Operators are complying with MiFID and also helping their clients to comply with MiFID and offering new services. They are however disadvantaged in a number of ways

that undermine their ability to compete against the less transparent markets. This disadvantage in turn could **damage the investors and issuers.**

- Some of the problems created by MiFID might especially affect the **smaller investors** and the **smaller (non-blue chip) companies** more negatively than others.
- Overall, MiFID has led to some changes that might have expanded the unregulated space for secondary markets. It needs to be assessed whether this **increases the vulnerability of the system to risks in the future.**
- In the interest of **improving the availability of equity market data, we propose establishing an industry-wide practice of providing data with a 15-minute delay for free.** This is already the best practice among FESE Members and we believe it would be beneficial for the market as a whole if other venues were also to adopt it.
- Finally, market operators have been cooperating with other MTF operators in order to define **a common statistical methodology**. We believe CESR can make a strong contribution to the quality, consistency and comprehensibility of the data in Europe by lending its support to a clear methodology where trading data and reporting are clearly defined and where double or multiple counting is avoided.

We believe that the **outcome of this Call for Evidence** should be:

- **<u>New CESR work needed in the form of Level 3 guidance</u>**: In view of the problems encountered so far, we especially recommend that CESR resume the work it had originally planned to do on the implementation of the **Systematic Internaliser** regime. We also believe that further work is necessary on the **waivers for RMs, MTFs, conflicts of interest and best execution.**
- **<u>CESR input to the Commission in relation to changes needed at Level 1 or 2</u>**: Certain legislative solutions (eg closing the loophole of transparency for investment firm crossing networks) may require immediate action before the MiFID review, which has now been postponed to 2010. EU policymakers will need to think innovatively about financial services regulation. In this sense, approaches taken by the US (consolidated tape, trade-through rule etc) may only be of limited use, because the EU Single Market faces specific problems that require European solutions adapted to its markets, supervisory and regulatory structure (eg different tax regimes, national legislations in non-harmonised areas).
- **<u>Industry solutions</u>**: Certain improvements can already happen through industry efforts, for instance by way of establishing a standard for equity market data with a 15-minute delay to be provided for free. We urge CESR to issue a recommendation (as part of Level 3) to declare this as best practice.

In the next section we provide our answers to CESR's specific questions.

II. Answers to CESR's Questions

Benefits

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 equity secondary markets?

Globally speaking, MiFID has led to some new commercial activity. We do not think it is appropriate to qualify all new commercial activities as a benefit to the market, but looking at them could be a starting point to understanding the impact of MiFID.

In this sense, we have comments on the impact of MiFID on (a) FESE Members as commercial entities; (b) FESE as a federation; and (c) the market as a whole.

(a) Impact of MIFID on FESE Members as commercial entities:

MiFID **has** changed the environment in which our Members do business. In some markets, and for specific segments or sets of securities, our Members face greater competition from other **types of venue operators**, that is MTFs and Systematic Internalisers, and from other **Regulated Markets** in their own or other jurisdictions. For some FESE Members, this aspect of MiFID did not mean a big change, since they were already operating **without** the concentration rule.

All FESE Members have taken the opportunity of MiFID to invest in new ways of serving their users. For instance, we have introduced **market segments** (13 Alternative Market Segments have been introduced as MTFs by our Members.) We have also introduced **new services**, for example: best execution tools; **new types of instructions**, for example to give priority in internalisation among clients' instructions of a single member; **smart order routing,** and services on **post-trade transparency and** disclosure of OTC transactions to our Members.

FESE Members also continue to invest in new and robust **technology to lower the costs borne by our clients.** This is not necessarily a product of MiFID but is related to it in an indirect way. It is important to stress that we **continue** to invest, since infrastructure providers in trading and post-trading in Europe have always been investing heavily in technology. Electronic trading in Europe was introduced in the early 1990s and these investments, along with investments in CSDs for dematerialisation, central account keeping and servicing, have led to major reductions in the costs for investors. More recently, RMs continue to upgrade their systems and communication lines to compete for latency (a process which began prior to MiFID) and have invested to provide proximity services and co-location services for 3rd parties. Even relatively smaller exchanges are committed to technology.

(b) Impact of MiFID on FESE as a federation:

First of all, some of the new entrants which are licensed as market operators have joined FESE as Members (eg Equiduct/Berliner Borse). Together with the new MTFs established by other Members, this development has enriched the scope of activities represented by FESE as a federation.

Another important impact of MiFID on our Federation is in the **data area**, where FESE plays a very important role. FESE's statistics on securities trading are used all over the world and its methodology has been the standard for the market for decades. In the aftermath of MiFID, we are cooperating with the MTFs operated by investment firms to achieve a common statistics methodology across Europe. In this regard, we would like to have the support of CESR in encouraging these efforts to clarify a methodology which will ensure a common and neutral framework of statistics for securities trading.

(c) Impact of MiFID on the Market as a whole:

As stated earlier, it is not immediately clear that any of the commercial activity caused or encouraged by MiFID is automatically a benefit for the market. There are two difficulties in making this assessment:

First of all, as with any legislation, one needs to establish 'cause and effect'. We strongly agree with CESR that one needs to have hard data. Changes should be ascribed to MiFID only if clearly evidenced. For instance, the increased use of technology in competition among venues is not necessarily due to MiFID. Similarly, some of the tentative conclusions raised as possibilities in DG Markt's background document published before the MiFID Conference of 13 November 2008 are not supported by unequivocal data, in particular with regard to trends in OTC trading, precisely because there is no reliable comprehensive information on the banks' trading activities at this point. Most notably, although many commentators have been ascribing the emergence of the latest MTFs to MiFID, it is not entirely clear that these venues were in fact a product of MiFID, given that - as discussed at one of the industry panels at the MiFID conference – most of them are active in a jurisdiction that never had the concentration rule before MiFID and the currently largest of the MTFs had started its operations *before* MiFID entered into force. In fact, according to CESR's MiFID Database, almost one third of the registered MTFs are promoted by RMs, and a small set of non-bank groups (MTS, ICAP, Tullet, etc.) roughly account for another third.

More importantly, we must not confuse the objectives of MiFID with its means. MiFID was aimed at creating a functioning passport within a Single Market and increasing competition among trading venues. However, neither the integration of the market nor the creation of greater competition was an end in itself. The ultimate objective was to generate **better and cheaper services for more and better protected users of the Single market**, in other words, for the **investors** who are putting their money at risk and therefore must be offered the highest protection standards, and the **companies** who want to attract capital. These expected benefits were even quantified in a way that constitutes a benchmark for evaluating the success of MiFID. **A London Economics study had suggested that the European GDP would rise by 1.1% principally as a result of a single market for trading**. The premise was that more competition for trading would lead to better results for European issuers thus reducing their cost of capital, and also benefiting European investors.

In fact, the **quality of secondary markets** can be assessed in four primary areas:

1. **Execution quality (as measured by market efficiency, lower costs for investors, increased liquidity, and innovation);**
2. **Transparency and price discovery;**
3. **Neutrality of venues; and**
4. **Level playing field.**

Looking at **these criteria**, the preliminary impact of MiFID on the market is not necessarily positive. In particular:

- There is no clear evidence that execution terms have improved;
- Price discovery has suffered especially as a result of the proliferation of execution venues with less or no pre-trade transparency such as SI, crossing networks, and some types of dark pools operated by non-neutral venues;
- Investors' orders are increasingly executed in venues that are owned by the sell-side which pose conflicts of interest; and
- Execution venues operated by neutral operators are restrained by overly restrictive rules and a generally stricter supervisory approach to their venues while the venues operated by investment firms benefit from rules that are not as comprehensive or operate in a regulatory vacuum.

In view of these risks for the market, policymakers and supervisors need to scrutinise the claims made by all commercial entities and base their judgments on MiFID on proper economic studies that truly ascertain what the effects have been**.**

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

The question refers to 'remaining barriers' to a level playing field. As such it is an important question but incomplete. In fact, we believe that the abolition of the option of a concentration rule has been implemented fully and we are not aware of any remaining obstacles to new venues competing with exchanges.

By contrast, we are aware of a rather significant *new* obstacle to genuine competition among venues. This is because MiFID classification of venues has not led, in practice, to a fair treatment of all venues in terms of pre-trade transparency obligations, due to three reasons:

(1) There are a number of investment firms running crossing engines in the UK and other jurisdictions that would more appropriately be classified as MTF operators or SIs. The activity targeted by internalisation rules is happening, but without the rules designed for it. We are convinced that the fact that there are only 13 SIs is not because only this number of investment firms are doing systematic internalisation, but rather because a lot of activity that should be captured by SI is not declared to be SI. Moreover, some of the crossing networks should be classified as MTFs. The current situation disadvantages RMs and MTFs because the crossing engines are doing the same business that MTFs/SIs do <u>but</u> they are doing this "OTC" and therefore outside of all pre-trade obligations.

(2) Separately, the pre-trade transparency rules applicable to RMs/MTFs – in particular RMs - have proven to be inflexible and inappropriate, hampering their ability to innovate and to attract orders from off-exchange. The high level principles in Level 1 seem to have been undermined by the Level 2 text which turned concepts such as waivers for Order Management Systems (OMS) into an exhaustive list of one permitted example of an allowed OMS being iceberg orders – the only one that existed in 2004. By contrast, brokers can clearly house and manage orders from clients keeping them entirely dark. This means that the Directive does not offer the flexibility needed to remain up to date with developments. This is an area where MiFID is preventing market innovation and failing to deliver a level playing field.

(3) Finally, according to an internal FESE survey, MTF are not supervised in an equal way, whereby those operated by RMs sometimes seem to be subjected to higher supervision standards than those operated by investment firms.

The overall result is that there is not a level playing field among all the venues. This does not promote a high quality execution environment for the end users, investors.

<u>What is the solution</u>?

We believe that several potential options can be considered:

<u>Short run</u>: Supervisors, under CESR's coordination, to inspect current crossing networks and identify a common approach, which could take the form of new Level 3 guidance.

<u>Long run</u>: To revise the definition of MTF and SI so as to close the loophole, or create a new category to subject the crossing engines to appropriate pre-trade transparency obligations.

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

We understand the question in terms of technological innovation as well as product and service innovation. On both accounts, it is realistic to believe that a relatively high **level of innovation** in the market would have come about **with or without MiFID**. In fact:

- RMs have been investing in technology for years. It is instructive to compare European exchanges with American exchanges, which, at the start of the ECN trading in the US, had **not yet moved to electronic trading**. By contrast, European exchanges have been offering electronic trading since the 1990s;
- It has to be noted that traditionally RMs have been technology exporters in the field of security industry tools (trading systems, derivative platforms, etc.), which reflects their high degree of technology expertise;
- Moreover, the RMs are continuing to invest in technology which allows them to offer more services and in most cases same or even better execution capabilities than those of the new entrants;
- Finally, certain concepts, like latency, have a relative value for different user groups and different markets. Technological innovation aimed at such parameters is not necessarily spread equally in every segment of the market.

Hence, great as the temptation might be, it is not easy to establish a clear link between MiFID and greater innovation.

Moreover, certain aspects of the transparency regime as it applies to RMs (eg pre-trade transparency waivers) hampers not only competition (as described under Question 2) but also innovation compared to non-RMs.

<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.

As pointed out in Question 1 in particular, there is limited evidence if any of clear benefits MiFID has generated for the market as a whole.

By contrast, exchanges have supported costs to adapt their systems to the MiFID requirement. In addition, certain problems due to MiFID are already clear, in particular with regard to the proliferation of non-neutral and non-transparent venues. The main parties affected by such problems are not exchanges, but rather the investors.

Moreover, the lack of a level playing field among execution venues creates unfair advantages for OTC trading and, in some cases, MTFs operated by investment firms.

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

Please also see our response to Question 2 for the three separate reasons for an unlevel playing field which we have identified.

These problems do have negative consequences for the market and make the offer of certain services by FESE Members more costly or even in certain cases not possible:

- A shift from multilateral to bilateral trading;
- A shift from transparent to non-transparent trading; and
- A shift from neutral to non-neutral trading platforms.

In other words, the lack of a level playing field means that the market (investors) cannot allocate the optimal level of trading volumes to each type of venue. Certain types of venues, those that offer bilateral, non-transparent and non-neutral platforms, are favoured.

This outcome is not only worrisome from the perspective of the quality of our secondary markets. It is also a cause of concern for the stability of our financial markets. The experience of the ongoing financial turmoil demonstrates that the structure of certain markets and certain products pose greater risks for the system as a whole. Therefore MiFID could lead to greater systemic risks by tilting the playing field in execution in favour of certain venues as described 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 question rightly refers to both implicit and explicit costs. More broadly speaking, execution quality can be assessed with reference to lower costs for investors, increased liquidity, and innovation, which we will address below in turn.

<u>Lower costs of trading for investors</u>?

- Direct costs **are only a fraction** of indirect costs such as **spreads and market impact.** If MiFID had increased market efficiency, we would expect to see narrower spreads, and a lower cost of capital for issuers. By contrast, spreads have widened – to what extent this is due to the crisis and to what extent to MiFID needs empirical analysis. Also, any benefits for users in terms of lower fees will only be useful if they can be sustainable over time. As in any market, the long-term sustainability of lower fees will depend on the long-term viability of the business model.
- In this context, we stress the difficulty of assessing the evolution of costs at a time of crisis, which makes it difficult to isolate the impact of MiFID. However, based on available indicators, there does **not appear to be any concrete evidence that indirect costs are lowered** as a result of the increase in the number of venues. Infrastructures' trading fees have declined in the last year, but they had also reduced in the years preceding MiFID. In fact, these fees have come down to a point such that the venues' explicit fees are **a very small part of the total cost to trade**, and probably not even noticeable to end-investors, **especially if the investment firms fail to pass on the reductions.** Any analysis done on this should track all trading costs, including **implicit or market impact costs**. These costs are likely to be an order of magnitude greater than exchange's trading tariffs.
- We also see a proliferation of new post-trading services, which adds complexity to the already complex picture of the EU post-trading landscape: in any case, this will result in additional costs of back-office systems update for many investment firms.
- Finally, there is no evidence to suggest issuers' cost of capital has decreased.

Increased liquidity?

Have European markets become more liquid over the last year **because of MiFID**? Again the financial crisis makes this hard to establish, as markets are clearly less liquid now than this time last year. The analysis will need to be robust so we can really understand the effects and, what is more important, isolate the individual effects of each possible cause.

Innovation?

Certainly we are seeing **faster** trading systems that have more **capacity** than ever. However, as indicated earlier, this was the trend we have been seeing for some time and can only be to some extent linked to MiFID. FESE Members have continuously been improving their technological platforms in order to respond to the new demand for execution speed, taking into account that speed is only one element of the total trading services that a market operator provides. Certainly, higher speeds make for a better market place, but in many cases the innovation was taking place before MiFID anyway. Moreover, as discussed under Question 3, elements of MiFID could be *damaging* innovation.

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 those concerns.

Fragmentation in itself is simply the flipside of competition. From a traditional exchange's perspective, as new entrants emerge, they could help unlock new trading strategies and opportunities. Therefore in principle, new entrants could make the pie bigger.

However, the fragmentation of liquidity we see is not only in terms of the number of venues, but also in terms of types of venues. Specifically, we see:

- More venues;
- More non-transparent venues; and
- More non-neutral venues.

As the market develops further, we do need to guard against the benefits of competition being outweighed by **the damage caused by the kind of fragmentation** we are seeing unfold in Europe:

More venues: We stated earlier that market impact costs as well as extra investment needed for back-office and monitoring purposes are likely to rise in a fragmented market with more venues.

More non-transparent venues: Moreover, the impact of MiFID on price discovery needs to take into account the increase in dark pools operated by broker-dealers. As stated earlier, these pools do not simply contain large orders that would not have come to the market if made transparent. On the contrary, they include smaller orders which are effectively taken away from the public pool of liquidity. This means that price discovery will suffer as these types of dark pools eventually continue to increase in importance.

More non-neutral venues: As stated under Questions 5, 10, 11, 16 and 18, the proliferation of non-neutral venues poses certain risks for investors which may not be fully addressed by the existing rules in MiFID (eg the rules for conflicts of interest, front-running and best execution).

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

First of all, as stated earlier, a significant amount of activity is taking place without being subject to MTF or SI transparency rules.

Moreover, these two types of rules also have their limitations:

- Even for those firms that decide to register as SI, **Article 27 pre-trade transparency requirements are not complied with in spirit or in letter**. For example, we have done research to find some SI quotes to assess their quality and usefulness. We have looked on vendor screens, and tried to get them from Markit Boat. However, SI quotes are difficult to find. We urge CESR to verify whether SI quotes comply with the MiFID requirements in terms of reflecting market conditions and availability.
- Moreover, broker-dealers (whether SI or not) do not provide adequate order display rules. However, this is **not** only a problem about non-compliance with Article 22 (although non-compliance is certainly one issue). More importantly, **the broker-dealers are not subjected to order display rules that are meaningful or comparable to those imposed on RMs and MTFs**. The RMs and MTFs are obliged to display every order that is sent to their systems, unless one of the MiFID waivers applies. This typically only excludes those orders large in scale to NMS, so the only dark orders are those above a certain nominal value for the most liquid stocks. By contrast, SIs are only required to publish a single *quote* representing all the unexecuted flow that may exist within the firm, whether that is client flow or proprietary. And if a further order is received, eg a small in scale order, there is no obligation to publish it – it becomes another dark order in the pool. As a result, brokers' internalisation pools have become dark pools which contain orders *of all sizes.* **This outcome calls into question not only the design and enforcement of Article 22, but also of the design of Article 27, which is conceived only as a quote disclosure requirement, instead of being a quote and order display requirement.**

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.

We currently do not have specific remarks concerning Liquid shares, SMS or OLS because we consider that the more important current challenges relate to off-exchange pre-trade transparency. Therefore we would like to reserve our position on these other questions until further consultations on these matters take place.

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?

We agree with the need of dark pools of liquidity that address some very particular investor needs in terms of a combination of limited transparency and high volumes, both embodied in specific market models and order types and/or sizes. Nevertheless, in order to avoid loopholes whereby orders that otherwise would have to be disclosed can be hidden from the market, a clear set of safeguards must be put in place and properly enforced. In this regard, we find that MiFID does not provide a sufficient regime for this.

In fact, the dark pools referred to in the question should be understood as not only **MTFs' dark pools** but also **investment firms' trading platforms.** As indicated earlier, a big portion of the trading volumes without pre-trade transparency rules is conducted in **the broker-dealers' crossing networks.** These are very similar to MTFs but are not regulated as MTFs and arguably raise more significant policy concerns because:

- Unlike MTFs, which have to go through a procedure of approval for their waivers, these crossing networks are not subject to any waivers; in fact, they are not subject to any transparency requirements and operate in a regulatory vacuum;
- As a consequence of the un-regulated environment in which they operate, crossing networks are generally not limited to orders large in size. Therefore there cannot be a presumption of the benefit of avoiding market impact; and
- They are by definition non-neutral, whereas all MTFs operated by market operators are neutral. (Please see the next question for more detail on this important problem.)

As a result of these considerations, we see more risks than benefits emerging from **broker-dealer** crossing networks**.**

By contrast, we find that **dark pools operated by MTFs** and **RMs** have a bigger potential of addressing a legitimate investor need without the same risks. In particular, there are some benefits for the market in dark pools operated by **neutral trading venues** accessible to all market participants, allowing the execution of large orders without impacting market price, and using an external imported execution price.

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 is certainly evidence to suggest that the share of dark liquidity seems to have increased, with many MTF dark pools and banks' owning OTC platforms. This might have consequences for the investors, the companies, as well as regarding systemic risk.

Risks for price discovery:

There is a significant risk of dark pools undermining the price discovery mechanism, which sets the right level of price for the supply and demand for a security. The Commission services inquired, based on the preliminary data available to them, whether dark MTFs might be taking business away from OTC. This is an interesting question. Since both venue types are 'dark', whether there is such a shift would have no impact on the level of pre-trade transparency. However, as explained in the earlier question, in principle MTF dark pools raise fewer policy concerns because they are subject to waivers, which they have to justify, as opposed to being subject to no transparency requirements.

Furthermore, since it is clear that dark liquidity is increasing – whatever the share of MTF vs OTC - we should pose the question as to whether that is what MiFID intended for investors. We need an open discussion on whether this is good for the investor, for the companies, and for systemic stability. A darker secondary market driven by non-neutral venues, thus not accessible to all market participants, not only means less transparency but also potentially less efficient price discovery, lesser investor protection and potential increase in information leakage. A particular important risk is indeed to the neutrality of venues, on which we elaborate further below.

Risks of the lack of neutrality in venues:

With MiFID, the number of non-neutral venues of trading has increased. Sell-side firms are operating MTFs, Systematic Internalisation platforms, or OTC crossing engines.

- This ownership structure does not immediately create a problem. Theoretically, with the right governance structure and rules, one can have good results with any kind of ownership. Some of the new MTFs are taking steps to assert their independence in various ways. There are also Chinese Walls within banks and the banks have to operate under certain conduct of business rules.
- However, the fact is, if a broker-dealer has a commercial incentive in the success or failure of a venue, then they have a potential reason to prefer that venue. So, if we look at the sheer increase in the number of venues operated by the sell-side, we have to at least flag this as a potential issue to monitor in the future, because neutrality is a very important quality in a venue. It is a core part of the integrity of a venue. Moreover, the financial turmoil has increased the importance of neutrality.
- It must be also noted that the double capacity broker/shareholder sows the seeds of conflict of interests: what is good for the owner (higher fees, for instance) may be bad for the investor/customer.
- If lack of neutrality is a problem, does MiFID provide the answer? In fact, the MiFID conflicts of interest rules are very limited. Best execution rules are a partial answer, but they are not there to address structural conflicts of interest.
- The fact is, it is a good thing for a venue to be independent from the interests of its member banks and users. That is exactly why formerly mutualised exchanges have de-mutualised and especially in Europe have evolved from that structure to a shareholder-owned independent structure. It is an irony that the investment firm-operated venues are a kind of return to the mutualised exchange structure, with all its potential drawbacks and risks.
- Therefore this issue merits further monitoring. We are especially keen to see the results of the probe recently launched by the UK FSA into this issue, in which they will look at crossing networks operated by investment firms AND broker execution for possible conflict of interest.

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

In Question 8, we described problems we have observed with regard to:

- A significant amount of trading happening while subject to no pre-trade transparency rules (crossing networks);
- The pre-trade transparency exemptions for RMs and MTFs being too limited;

In particular, we would like to reiterate that:

- Article 27 pre-trade transparency requirements are not complied with in spirit or in letter. We urge CESR to verify whether SI quotes comply with the MiFID requirements in terms of reflecting market conditions and availability.
- Broker-dealers (whether SI or not) do not provide adequate order display. We encourage the policymakers and supervisors to re-asses both the design and enforcement of Article 22, and the design of Article 27, which is conceived only as a quote disclosure requirement, instead of a quote and order display requirement.

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?

This question is for users of data. As publishers of data, we refer to the points we raised in the earlier question with regard to problems with transparency.

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.

We have already covered certain problems that concern **the scope of data** (ie certain activities/trades/quotes/orders not being disclosed whereas they should). We also raised a question about the **relevance and availability of SI quotes** published.

Here we will address the quality of OTC data. Our comments should be seen in the context of the important role played by FESE Members in the European market data industry. This industry is subject to **competition**, which has led to higher efficiency and lower costs over the years**.**

Our Members employ **a varied range of fee structures** for market data services and products. Members' terms and conditions are designed to maximise the long-term distribution of content and transparency of capital markets, taking into account the many distribution and business models among channel distributors and user groups. Hence, there is **a high degree of tailoring of products and solutions to best meet the needs and demands of the exchanges' clients**. Fee structures generally follow this tailoring, with retail users generally paying less (or getting for free) content that usually slightly differs from that for professional investors in terms of data delivery, latency and depth. It is important to note that the providers of data have an incentive today to innovate to create products that meet different customer needs – which is a characteristic of the market-led structure of the market which fosters innovation and customer focus.

FESE Members take the necessary steps to ensure that market data which they distribute has l**ow latency.** Although all professional users demand low latency, the expectations from the users with regard to latency are diverse. **Electronic (algorithmic) trading** sets the highest standards for latency.

Delayed data of RMs (**provided generally within 15 minutes**) is **usually available free of charge.** Such data also has information value for the market. The 15-minute period is an industry standard among Market Operators. By contrast, a new entrant (Markit Boat) does not provide delayed data for free before 2 hours. We believe that the market as a whole would benefit from establishing **an industry standard for free equity market data based on 15 minutes for all data publishers.**

A number of different **technical channels of distribution** are used to grant access to market data, including direct feeds, third party access provider and the internet, each presenting different characteristics suited to different client groups.

Looking beyond their own services, RMs have some observations to make regarding other service providers in relation to **the quality of OTC post-trade data** provided by investment firm-owned data providers:

- The real-time data is provided at the end of a 3-minute period as a rule rather than as an exception;
- The delay of data is much longer than the industry standard (in some cases up to 3 days) while being nominally in line with MiFID requirements;
- Usually no information about the execution venue is given (only OTC), again while being nominally in line with MiFID requirements;

- Double counting of trades, very significant at the beginning, is only slowly being addressed [although it is being addressed, as outlined below].

15. Do you think that 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 process the overall efficiency of the markets search costs)? If so please elaborate on those concerns.

Overall, we are not aware of any significant problems with the European pre-trade data dissemination system apart from the inaccessibility of SI quotes as already stated above. A range of solutions to aggregate and disseminate pre-trade price data already exist. This applies also to post-trade information. Information providers compete across Europe to develop products to provide commercially viable services that meet investors' needs.

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

In the first part of our response to this question, we will address data. In the latter parts, we will look at some of the problems encountered in the wider context of best execution, including implementation of execution policies and conflicts of interest.

(a) Data and Best Execution:

We believe that the current availability of data is sufficient to facilitate best execution as defined within MiFID[1].

We would like to specifically address a problem raised by some commentators, who have stated that market data access has become 'more costly' after MiFID. We find this statement misleading. In fact, there is evidence to show that the addition of new MTFs has not increased the cost of market data to users, eg because MTFs are generally not charging for their market data as their data are currently rather used as a marketing tool by the respective MTFs, and in general data from the most liquid markets are used for the price formation process.

Moreover, **market data fees** of RMs (in the category of fees paid to market data sources) constitute only a small portion of the overall costs of market data access (composed of not only data source fees but also fees paid to market data vendors, cost of supporting market participants' internal distribution platforms and costs of administration).

Furthermore, given the characteristics of the **best execution** requirement in MiFID, it is not legally mandatory (or commercially necessary) for market participants to have access to low-latency market data for all European markets. Investment firms can define their execution policies with the use of delayed or even historical market data (which are widely available for free). Moreover, any execution venue that an investment firm has connected to in order to comply with its defined execution policy will provide the firm with the necessary access to market data as well as access to execution. These facts need to be taken into account when considering the state of availability of data in the context of MiFID.

For these reasons, we do not believe that the current teething problems encountered in the area of data pose any long-term problems for best execution.

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[1] One of our Members (NASDAQ OMX) has different views on this issue which are explained in their own reply to the Call for Evidence.

Separately, as we pointed out in our response to the European Commission's Call for Evidence in 2008, it been observed that it has been difficult under certain circumstances to locate where the trades are disseminated. In particular, issuers and their professional associations have expressed this concern to some of our Members that they are not able to have an exhaustive view of the trades executed on their shares and the related prices when these are not reported via a widely used channel. Issuers can have a problem particularly when trades are reported only on a website, which, for instance, might make only the last 10 trades visible. This kind of unevenness in the dissemination quality impairs best execution by preventing a full comparison of the prices offered by different venues. A solution for this could be found in additional Level 3 work by CESR for instance to improve the standards for publication on websites.

Please see our response to Question 17 for further details.

(b) **<u>Best execution in a fragmented environment</u>:**

Since the CP does not have a separate question on **<u>best execution</u>**, we would like to use this opportunity to describe certain other **<u>problems</u> regarding best execution**: Inconsistent implementation due in part to imperfect enforcement; loose legal text, and conflicts of interest. We address these in more detail below.

<u>Inconsistent implementation due in part to imperfect enforcement and loose legal text</u>:

A recent study by Peter Gomber from Frankfurt University[2] showed that investment firms in Germany were minimalistic in the way they implemented the best execution requirement, covering their minimum legal obligations only, and in some cases failed to provide adequate information to their clients.

In fact, we as FESE have done a preliminary study of **European execution policies**, and found **very similar results** to what the Frankfurt University discovered for Germany. Overall, our impression was that the **execution policies surveyed did not have adequate depth and were not likely to provide sufficient information to the investors**. Although the firms had informed their clients on their new policies, they had done this in a very general and minimalist manner and failed to give investors any meaningful information as to where or how the trade will be executed.

Some of the problems we detected are as follows:

- A list of venues **was not always** included in the execution policy (this was withheld in some cases for 'business confidentiality reasons'!).
- There was an **insufficient distinction** between products or investor categories.
- The factors used in the choice between the venues in the policy were presented in **vague terms**, or not at all.
- Retail investors were sometimes **not** told that the total consideration of costs is the most relevant factor.
- In some cases, **prior consent** to the execution policy might **not** have been obtained.
- Some firms seem to have relied on implicit/tacit consents where the **consent should be express** (when execution outside a RM or MTF is obtained), or have placed an up-front vague declaration in their terms and conditions. Some investment firms might believe that their regulators accept a tacit approval as sufficient even though this goes against MiFID.
- And finally, some venues may be used by executing brokers without adequate knowledge of the associated post-trade rules with the consequence that certain factors important to best execution, such as the **certainty of settlement,** may not be taken into account.

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[2] Gomber, Peter; Pujol, Gregor; Wranik, Adrian. The Implementation of European Best Execution Obligations in Germany, In: EFL Quarterly 04/2008, pp. 4-5.

Many of these problems can probably be addressed **with <u>better enforcement (via CESR coordination)</u>.**

<u>(c) Conflicts of interest</u>:

Another problem that probably also requires a legal review is **<u>conflicts of interests</u> in general**. Investors might not be getting a good execution because of conflicts of interests the broker-dealer might have with **ownership** of alternative venues. There is anecdotal evidence of firms preferring the MTFs in which they have ownership stakes. If this were the case, it would have to be addressed. (Please look at our answer to Questions 5, 10, 11 and 18 for more discussion on the importance of neutrality of venues).

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

We firmly believe that commercial forces are able to deliver the level of consolidation needed for an efficient and safe EU Single Market.[3]

Some commentators have raised the question as to whether a US-style mandatory consolidated tape should be considered in Europe. Such a mechanism was indeed considered as a possibility and expressly rejected during the negotiations of MiFID. Today, there are even stronger reasons why it would not be necessary.

As the main subject of this consultation is not data, we will limit ourselves to a brief overview of some of the problems with a consolidate tape proposal. Such an approach would:

- limit competition and thwart innovation;
- lead to major structural and regulatory change;
- result in inefficient duplication of services;
- undermine European provisions for best execution; and
- be of limited use if recent trends relating to the use of dark pools continue.

A legislated consolidated tape would impose a one-size-fits-all solution across Europe, thus removing choice by **limiting competition and thwarting the development of innovative solutions**.

We also believe it would require **major structural and regulatory change** to be viable, leading to unjustifiable development costs and upheaval across the market.

For example, a large and expensive industry body like SIAC in the US would be required to normalise all these feeds and deliver them to the market. Regulation-led costly development would be needed to force all participants and venues to connect as they do in the US. Instead of using existing infrastructure and software, new or expanded communications links and feed handlers would be likely, bringing significant new costs and impacting down-steam systems, including complex trading applications. The network bandwidth and processing power required to aggregate and distribute real time data across all Member States/exchanges within the EU, would be extremely expensive - and would continue to grow.

The location of the SIAC and the tape would potentially be a contentious and politically sensitive decision. Importantly, geographic location of a data source is increasingly significant for latency sensitive traders (such as high frequency traders) who want data directly without any delays. Reduced latency is incredibly important and this is demonstrated by fervent demand for co-location or proximity hosting. The reality is therefore that some

[3] One of our Members (NASDAQ OMX) has different views on this issue which are explained in their own reply to the Call for Evidence.

venues and firms would benefit and some would lose from wherever the ticker plant for a mandated European consolidated tape was physically located. A further issue is that US tapes only consolidate top of book data to deliver a "National Best Bid and Offer" (NBBO), while Europe's algorithmic driven traders would want full depth of book data, so would continue to take data directly.

Inefficient duplication of services is the likely outcome, as large firms in Europe would always opt for direct feeds from venues over a consolidated tape.

If the system were to develop along the lines of that in the US, Europe would also need to change its best execution definition, to reduce existing flexibility and prioritise price. This is incredibly pertinent, since recent developments such as the collapse of Lehman Brothers have shown that the **multi-parameter definition that the EU has under MiFID is superior**, as it allows important factors such as settlement certainty and counterparty risk to be prioritised if deemed necessary. It is worth highlighting that **US stakeholders do not see their system as a panacea**. Indeed, US commentators have often noted the inefficiencies and costs of the arrangement.

A final observation is that as we see an increasing trend for brokers to operate dark pools outside the scope of organised trading venues (i.e. regulated markets and MTFs), **the usefulness of consolidated pre-trade information** from the organized venues **will be undermined**.

Whilst we are convinced that a consolidated tape would be an unfortunate development, it is clear from comments made by participants at the recent MiFID conference and elsewhere that there are frustrations within the market. We have mentioned these in Question 16, where we have also described the market-led solutions that are already in motion to address them. Market wide concern about the **quality of reported data** across different trade reporting venues results essentially from the adjustment process for MiFID and we do not believe any further regulatory intervention is currently required: market pressure should be sufficient to rectify this issue and we do not see how a consolidated tape would counter this specific problem.

<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?

Please see our response to Question 1. In particular, we would like to reiterate our view that:

- MiFID has led to some new commercial activity.
- There is not yet sufficient evidence to demonstrate that investors and issuers are benefitting from the commercial activity caused by MiFID in terms of better execution terms, higher liquidity or innovation.
- Some of the rather negative side-effects created by MiFID might especially affect the smaller investors and the smaller (non-blue chip) companies more negatively than others.
- The Directive may be failing in its aim of creating genuine competition among venues due to the lack of a level playing field among venues.

- The proliferation of non-transparent and non-neutral venues might be undermining both the price discovery process and the market integrity.
- MiFID has led some changes that might have increased the vulnerability of the system to risks.

With regard to the last point, we see three separate problems worthy of further study:

- **MiFID might have led to a shift in favour of less regulated and less transparent markets;**
- **MiFID might not be providing sufficient investor protection;**
- **Post-MIFID markets have a lower level of market surveillance.**

Taking each of these in turn:

MiFID has created a dynamic in favour of private (bilateral, non-neutral, non-transparent) and away from public (open, neutral, transparent) markets in Europe. It is therefore noteworthy that **MiFID might have led to a shift in favour of less regulated and less transparent markets.** This is ironic in light of the lessons from the ongoing crisis, which has shown the **importance of market structure to systemic stability and investor protection**.

As for **conduct of business rules** (not covered by this Call for Evidence but very much linked to the quality of markets), MiFID applies to **all financial instruments but how it applies to various client categories,** might need to be reviewed. One can call into question whether the **client classification and COB regimes of MiFID are right. The crisis showed that all investors** can make **wrong decisions based on faulty information**: therefore the assumption that professional investors, and even eligible counterparties, are **by definition** and **in all cases** able to take care of themselves, is now clearly put into question. Therefore, future assessments of MIFID should look at whether the professional investor category and the lighter protections that go with it continue to be appropriate. We might also want to look at whether certain protections should apply even to eligible counterparties.

Finally, we are concerned that the market surveillance of the newly established MTFs may not be adequate. We are aware that some of the new venues are also trying to get involved in market surveillance. However, by and large these new venues do not invest in market surveillance and regulatory functions as much as the RMs in terms of budget of staff. This is not just a matter of commercial choice but also because the legislation expects more from RMs on this point and the supervisors seem to hold venues operated by investment firms to lower standards of market surveillance. In fact, Regulated Markets' role in maintaining a high level of market integrity and principles such as corporate governance is widely recognised (eg by organisations such as the OECD[4]). However, from a broader perspective, the supervisors may need to assess carefully whether market surveillance functions expected from different venues are sufficient and whether there is adequate market integrity in this new trading environment.

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

No additional comments.

[4] The Role of Stock Exchanges in Corporate Governance, Background Paper and Issues for Discussion, 19-20 November 2008.