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## **European Securities Markets Expert Group (ESME)**

***Fact finding regarding the developments of certain aspects  
of  
pre-trade transparency in equities under MiFID***

The European Securities Markets Expert Group (ESME) provides legal and economic advice to the European Commission on the application of the EU securities Directive. ESME was created by Commission Decision 2006/288/EC of 30 March 2006 (OJ L 106, 19.4.2006, p.14).

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# 1. Introduction

We have been asked by the Commission to respond to certain questions pertaining to the pre-trade transparency requirements set out under MiFID. Before responding to those specific questions, some background to the main regulatory challenges in respect of transparency is provided under *Section 2*, followed by a short historic outlook in respect of the market micro structures in Europe prior to MiFID under *Section 3*. We continue by making a short recollection of the requirements that were introduced through MiFID (*Section 4*), followed by a short general description of market developments after 1 November 2007 (*Section 5*). We then respond to the direct questions raised by the Commission under *Sub-Sections 6.1-6.3*. A summary of our conclusions is finally presented under *Section 7*.

Our analysis has strictly followed the transparency regime set out in MiFID. Essentially, this means that we have only assessed the pre-trade transparency requirements for shares admitted to trading on a regulated market. In other words, we do not express any view in respect of the regulatory policy for other asset classes or shares traded only on an alternative trading venue (like AIM, Alternext, Entry Standard, First North and equivalent trading venues). Nor have we made any assessment of the appropriateness of transparency requirements for bonds, which have been commented upon by ESME separately.<sup>1</sup> Bearing in mind that ESME recently published a paper on post-trade transparency<sup>2</sup>, we have made a few remarks also in respect of publication of recently concluded trades in this report. We have done so because – in our view – pre- and post-trade transparency to a certain extent has to be viewed together when assessing whether the regime is designed in the most optimal manner from a market perspective.

In responding to the questions raised by the Commission, recognizing the limited time at our disposal, we have tried to ask ourselves the following questions:

- (i) What are the objectives behind the transparency regime set out in MiFID?
- (ii) What are the problems? and
- (iii) What are our suggestions to resolve or mitigate such problems?

While the answer to (i) is given, (ii) can surely only be reflected as an indication of potential problems because of the limited time MiFID has been in force. Hence, any suggestions made by us in this report should be viewed in light of that, and it might be sensitive for the Commission just to keep some “problems” on the radar screen for yet some time, in order to find out whether or not the problem will become real (from a more sustainable point of view). It appears as if CESR has taken the same “wait and see” – approach in respect of its recently published report on the functioning of equity secondary markets.<sup>3</sup>

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<sup>1</sup> See [http://ec.europa.eu/internal\\_market/securities/docs/esme/answerstoquestions\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/answerstoquestions_en.pdf)

<sup>2</sup> See [http://ec.europa.eu/internal\\_market/securities/docs/esme/report-data-availability\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/report-data-availability_en.pdf)

<sup>3</sup> <http://www.cesr.eu/popup2.php?id=5771>

## 2. Market Transparency: Context and dilemma

This section gives a short overview on the relevance that market transparency has in the overall framework of trading. The content may be helpful to better understand the underlying economics and the resulting motivation of the involved parties and their views towards a 'right' market transparency regime.

MiFID intended to increase competition in the European trading landscape by the abolishment of concentration rules. The flip side of that very coin is fragmentation of liquidity across several venues. At the time, one has been very well aware of this adverse effect and eventually realized that only **transparency** can solve the resulting issues: The overall benefits of competition can only outweigh the adverse effects of fragmentation if investors know at which prices they can trade, and what volumes are currently available on each venue.

But there is a problem with transparency. While everybody likes transparent markets, it appears rational from each individual investor's point not to contribute to it. Actually, this case is an application of the 'public goods' problem to securities markets: Every individual likes to benefit from the consumption of the public good (e.g., street lights; public radio & TV broadcasting), but nobody likes to contribute efforts towards its production (e.g., communal taxes, public broadcasting license fees). The same holds for information on investors' orders: From an individual investor's point it is beneficial not to display his own trading interest to the market, while each investor wants to learn about the trading intentions of others.

### **Excursus:**

#### **Why would an investor want to hide his trading intentions from others?**

An order contains valuable information on the current market value of a company: Assessing a company's fundamental value requires extensive research, e.g., analyzing the company's annual reports; attending shareholder meetings; monitoring industry developments etc. To make a trading profit, investors will attempt to buy stocks that are in their view undervalued and sell stocks that are overpriced. Acting on the market, their orders contribute to the public price discovery process and drive prices towards the 'right' direction. In other words: Market forces drive asset prices towards their fair values.

Consequently, as everybody likes to see the orders of other investors, each individual investor dislikes showing his orders to others. An early display of their trading intentions will reveal their assessment on the stock's fair value to the general public. This enables others to adapt their assessments on the stock's value more quickly. The result is a swift movement of prices, resulting in a smaller trading profit for our investor. This is beneficial to the whole market, but detrimental to the investor.

Considering these incentive structures, regulators have two basic options to ensure a proper functioning of markets: One solution is to allow for general trading "in the dark", where no investor displays his orders to the public. In order to ensure fair prices for everyone, this option mandates the consolidation of all order flow in one single venue. This has actually been the case in some continental European countries before MiFID, and explains the historically evolved hidden auction order books of continental stock exchanges in Europe.

The other solution is to allow for competition. This case requires the *mandatory* display of market participants' trading interests to the public, as investors do not have an intrinsic motivation to display their orders to the market. Only if all participants must display their trading interest to the public, investors can direct their orders to the venues providing the best prices. This general vote for transparency has originally been foreseen by MiFID and is one of its guiding principles.

Apart from these general guiding principles, the regulators have acknowledged the need for some exceptions from the strict transparency requirements. These exceptions, which eventually resulted in the "waivers", were originally meant to account for the economic necessities and existing trading practices (e.g., the exemptions for large orders in order to prevent adverse price movements). In order to ensure consistency with the spirit of MiFID and to prevent damage for the European equity trading landscape, however, the waivers have to be restricted to an absolute minimum.

### 3. Pre-trade transparency in Europe prior to MiFID

Before 1 January 2007, a variety of market models for trading in equities applied across Europe. Obviously, there are still substantial regional differences but the market transparency requirements have essentially been harmonized through the requirements in MiFID. The differences can broadly be categorized as follows:

**Order driven markets/market maker markets/hybrid markets:** MiFID has not resulted in any substantial changes in respect of this categorization. Historically, certain markets have been organized as *order driven market* which simply means that orders are entered into the trading system where they will be subject to an auction (either at a defined point in time, or continuously throughout the day, or both). In such market models, orders are normally ranked based on price and time. Some markets also give priority for internal crossings before time (i.e. a member that crosses its own orders in the system would get priority compared to all other orders at the same price). This market model typically applies in the Nordic markets.

An order driven market is in contrast to a *market maker market (or quote driven market)*. The probably most predominant example of a European trading venue that is based on a market maker model is London Stock Exchange. Such markets rely on trading participants that have undertaking a contractual obligation to provide liquidity as market makers by offering quotes against which orders can be executed. One of the advantages of this market model is that shareholders normally are guaranteed an exit from their positions also in distressed market conditions (or in circumstances with very poor liquidity).

However, the distinction between the two typical market models above has since many years become somewhat blurred, since markets originally based on a market maker model have implemented also order driven facilities (like LSE) or the other way around (like certain European NYSE Euronext markets and the Nordic markets operated by Nasdaq OMX). Hence, most modern markets have adjusted their operations to a market model that is often referred to as a *Hybrid Market*.

**Concentration Rules/Internalisation:** Another way to cut the differences would be to make a distinction between those markets that required all trades to be carried out on the exchange and those markets that recognized internalization to take place. For example, in France, Italy and Spain all equity trading (except for certain large size trades) had to be done in the systems provided by the exchange and this model were sometimes referred to as *a Concentration Rule*. Some other jurisdictions, like UK and the Nordic countries, recognized that intermediaries executed trades internally (*Internalisation*), however subject to a requirement to report such trades to the exchange either promptly (normally within 5 minutes) or with an acceptable time delay (for block trades). The reporting requirement practically resulted in a one stop shopping approach, i.e. also such markets applied a sort of concentration rule which effectively hampered competition. This was revamped through MiFID, which has facilitated true competition in respect of European equity trading. In Germany prior to MiFID no legal requirements existed to publish orders or quotes for trades taking place outside an exchange, and this also applied to post-trade data. Thus, MiFID increased pre- and post-trade transparency in the OTC market in Germany significantly.

#### **4. Requirements and objectives in MiFID**

The objectives behind the transparency requirements in MiFID are set out in Recital 44. The recital makes it clear that the aim of such requirements is twofold; first, they are justified by investor protection concerns, and second, they are justified by the interest of ensuring the smooth operations of the securities markets.

The idea behind the investor protection justification is that investors – in particular retail investors – shall be able to assess that they are treated fairly when making transactions on the equity markets. For example, in order for an investor to be able to assess whether an intermediary has complied with its best execution requirements, such investor need to have access to the prevailing market conditions at the time of the trade as well as transparency regarding the respective transaction fees.

Without diminishing the importance of the investor protection aspect, the other aspect – the smooth functioning of the markets – was the one that was subject to most discussions at the time MiFID was under consideration. Those member states that relied on concentration rules feared that abolishing such rules would result in more fragmented markets and that such development could have a negative adverse effect on the liquidity and the price formation process. On the other hand, those member states that allowed internalisation argued that their market model actually supported liquidity and price formation, as market makers had to display their quotes to the public in order to attract order flow or participants had to report internalised trades to the exchange, and hence were more efficient. However, it should be recognized that those member states (e.g. the UK and the Nordic countries) required mandatory reporting of trades to the exchange for transparency purposes, and that trading model could therefore be described as a concentration rule “light”.

In order to mitigate the risk of too fragmented markets with negative consequences, MiFID intended to introduce a quite comprehensive regime in respect of transparency (pre-trade as well as post-trade). The idea was that far reaching transparency

requirements put on trading venues and intermediaries would incentivise market forces to develop new (or use existing) business models for consolidating market data and distribute it through various channels. Such initiatives have also been taken, for example Markit BOAT™ in respect of publication of post trade data, and so called Trade Data Monitors (TDM) for aggregation of market data in the UK.

In respect of pre-trade transparency and the background above, MiFID broadly requires transparency of trading interests (pre-trade data) pursuant to the following articles;

**The Client Limit Order Rule (Art. 22(2)):** An investment firm that receives a client limit order – which is not large in scale compared to normal market size – shall immediately make it public in a manner that makes the order accessible to other market participants, if such order can not be executed immediately “in house” on prevailing market conditions. This requirement does not apply if the client instructs otherwise. Member states may decide that this requirement is met, if the order is passed on to a regulated market or an MTF. The competent authority may waive the requirement on the same conditions that apply for waivers granted to a regulated market pursuant to Art. 44(2).

**Pre-trade transparency requirements for regulated markets and MTF’s (Art. 29 and 44):** Regulated markets and MTF’s are required to publish current bid and offer prices and depth in respect of the trading interests that are advertised through their systems. The information shall be provided to the public on “reasonable commercial terms” and the information shall be made available on a continuous basis during normal trading hours. Competent authorities may grant waivers from this requirement if duly justified by (i) the market model (e.g. crossing systems or negotiated transactions), (ii) type and size of orders (e.g. “Iceberg Orders”) and (iii) in respect of “orders that are large in scale compared to normal market size”. The minimum level sizes and time frames for delay are set out in the Commission MiFID Regulation (EC) No 1287/2006, ANNEX II, Table 2. The MiFID Regulation also sets out more detailed requirements in respect of pre-trade transparency under Chapter IV.

**Pre-trade transparency requirements for systematic internalisers (Art.27):** The perhaps most controversial and debated part of MiFID was the introduction of the notion of systematic internalisers (SI’s). Operations as an SI does not *per se* require a MiFID–license, but an investment firm that executes client orders against its own proprietary book on a continuous and systematic basis should be categorized as such by its home country supervisor in order to ensure a high degree of market transparency. The consequence of such classification is that the SI will be required to publish firm bid and offer prices in shares for which it acts as an SI. However, this requirement does only apply in respect of liquid shares, based on the annual assessment that is made by the European supervisors and published by CESR on its web site. An SI is only required to publish quotes “on request “ in respect of shares that are not classified as being “liquid”. The requirement to publish quotes does only apply in respect of sizes that are below the “standard market size” (SMS) for the particular share. The supervisors calculate the SMS for different liquid shares, and group them into at least 7 separate classes based on the average value of transactions for the respective share. Hence, an SI is not required to publish bid and offer prices for sizes above SMS, which means that an implicit waiver apply for larger volumes

also in respect of SI's. It should be emphasised that the requirement to publish firm trading interests is not a market maker requirement, but entirely driven by market transparency concerns. For example, an SI is not required to trade with anyone that is willing to do an opposite trade at the published price; it is only required to trade with its "clients" and it is basically up to the SI to define who – based on objective criteria – should be eligible to become a client in that respect.

Finally, there are in principle three channels for publication of pre-trade information recognized under MiFID, and those are (i) publication through the facilities of a regulated market or an MTF, (ii) publication through the facilities of a third party or (iii) publication through proprietary arrangements (e.g. a website).

## **5. Developments after MiFID**

The most evident development after MiFID has been the launch of a number of new "exchange like" trading venues operating under licenses as MTF's. Such markets embrace ventures such as Chi-X, Turquoise, Bats Europe, Nasdaq OMX Europe and Burgundy. They do not have any direct relation to the issuer, but rather offer trading on an unsponsored basis in – normally – European blue chip companies in direct competition with incumbent exchanges. Recent figures (31 March 2009) suggest that these new trading venues counts for as much as 10,99 percent of the trading volumes in DJStoxx 600 constituents, and that Chi-X alone represents close to 7 percent of that volume. The figures are even higher for some markets, in particular the UK market.

Some explanations to the developments above are (despite of MiFID) the use of market making arrangements as well as technology developments (such as the introduction of smart order routing – or SOR – facilities).

The development of various "Dark Pools" has also been apparent, and gained in importance. They have in particular developed in the US market since quite some time, and the business models have following MiFID been rolled out in Europe as well. Such pools are in principle not a new feature; in fact they have historically played a pivotal role in many markets as a facility for executing large block orders that could not be executed in the public market without negative consequences in respect of transaction costs (i.e. risk of market impact or exposure to immediacy costs). However, innovations in transaction technology has resulted in more efficient order handling in such pools, and innovation has resulted in that they in fact appear as "market places" more than what was previously the case. Dark pools are developed and offered by specific service providers (such as Posit, Liquidnet, Euro Millenium and others) or developed as in-house crossing networks by sell side firms (such as GS SIGMA X, UBS PIN, MS Pool, NX and others). The regulatory status of these venues appears to be fairly opaque, since some operate under licenses as MTF's , a few have opted to be labeled as SI's and the rest are providing execution OTC. The in-house crossing networks, in particular, fulfil a dual role as client order crossing engines as well as internationalization facility where they execute client orders against their own trading book. All these venues have resulted in increased competition in terms of equity trading, and various sources indicate that they attract more that 30 percent of the volumes in European blue chips trading.

To complete the picture, many lit venues (i.e. incumbent exchanges and lit MTF's) also have developed facilities for execution in dark pools, in some instances as separate execution facilities, in some instances integrated with the transparent order books.

Developments due to MiFID together with innovations in transaction technology have also resulted in changed patterns in respect of execution across a multiple of venues. The use of smart order routing (SOR) facilities has gained momentum, and is offered by both sell side firms as well as trading platforms. The use of a SOR-facility would direct an order to the venues where it is possible to obtain the best conditions for an individual order. Hence, an order could be sliced into fragments, and executed across two or more venues where the share is traded. Further, the increased importance of algorithmic trading and direct market access (or even sponsored access, as offered by a few markets) contributes to this development, and has – together with SOR – been one of the main drivers behind the increased fragmentation. Other developments worth mentioning is the development of proximity – or hosting – services, which essentially mean that participants are offered space for placing their own servers close to the servers of the market places. One trend is that servers provided by market places as well as users are placed in data centers particularly developed for this specific purpose. Some examples are the Cannon Bridge data centre and the Basildon data centre in the UK which both hosts (or will host) machinery for some exchanges from continental Europe, in order for them to get closer to their UK based participants. The driver of all these developments is the increased importance of latency – or speed – in respect of execution.

Availability of market data is obviously imperative in order to be able to benefit from the developments above. While participants prior to MiFID only needed market data from the primary trading venue (notably the incumbent exchange), such data is now needed from – in theory – all venues where the share is traded. As further developed below, such consolidated market data products are now developed by a number of vendors as well as in-house by some sell side firms. Access to it has increased in importance due to the fragmentation, and might increase in the future in case volumes at the new alternative trading venues continue to pick up.

One concern is that access to consolidated market data should be broadly available at a level playing field in order to prevent adverse consequences for the market efficiency at large (because the information available in the markets will not necessarily be reflected in the prices at all relevant market at a given point in time).

## **6. Questions raised by the Commission**

### **6.1 Availability of Pre-trade data**

#### **6.1.1 Under what terms are pre-trade transparency data in equities currently made available?**

Respondents comment that pre-trade data and post-trade data normally are distributed together and on equivalent terms. Hence, the feedback provided in respect of the assessment of post-trade data is relevant also for the purposes of this assessment. In general, data from regulated markets and MTF's seems to be available to the public on a level playing field at high quality and at reasonable terms.

Some respondents, notably those representing lit trading venues, argue that it seems to be necessary to focus on the un-availability of pre-trade data which is completely outside the rules of MiFID. They consider that this is either due to lenient interpretation of MiFID rules (e.g. in case of SI's) or due to the fact that some market participants operate completely outside the rules of MiFID. In addition, they voice that EU equity markets have become less transparent after the introduction of MiFID than they were before.

Respondents also comment that the terms for provision of market data in principle are the same today as prior to MiFID. The new entrants – the lit multilateral trading facilities (MTF's) – have so far applied fee holidays for market data, and hence the total fees are therefore basically on the same levels as before. However, the sustainability of practicing fee holidays has been questioned by one respondent, with reference to the low margins on which such MTF's operate. One respondent also indicate that the prices for market data reflect their market values: As home markets are seen by market participants as venues providing reliable reference prices, the value of these prices is correspondingly high because the informational content of these reference prices is high. On the other hand, the informational content of liquidity available on newly established MTF's seems to be rather limited, as liquidity providers on these venues by and large seem to mirror the liquidity available on home markets. The currently low price levels of MTF's market data seem to be the result of the market mechanism which ensures that products and services are priced according to the value they provide to market participants. As liquidity further shifts from home markets to MTF's, they mean that the market value of this data should increase accordingly.

Also, some respondents raise a concern that the new fragmented environment has created an increased demand for consolidated market data, and that such market data products are developed and provided e.g. by vendors and through in-house developments at certain sell side firms. The production of consolidated market data is claimed to be costly due to many factors such as (i) the need to obtain market data at existing fees from all relevant execution venues, (ii) lack of common standards which would simplify the consolidation, (iii) differences in data quality across execution venues (for example, there is no indicator of execution venue in post-trade data reported from OTC crossing systems) and (iv) increased costs for technology. The

number of new trading venues has raised this concern even further. If MTF's start to introduce fees for their market data that will according to one respondent most likely also become a cost driving factor.

One exchange has noted that it has reduced or at least kept stable its equity market data fees for over more than three years now.

Apart from the terms of availability, certain respondents raises the question that it needs to be considered that some market participants seem to provide less transparency than was originally desired by MiFID, and refer to the fact that

- Currently, 13 SI's are registered in CESR:s MiFID database. Reports from various market participants indicate that the quality of SI's pre-trade transparency data that is made public is extremely limited, if not to say useless. This lack of display of firm quotes has enabled these investment firms to completely withdraw from the public price formation process and to execute their client orders in a discretionary environment. In this context, it appears noteworthy that data obtained from reference markets seems to serve as guideline for the respective executions.
- Other parties than regulated markets, MTF's and SI's include, *inter alia*, in-house crossing networks of large sell side institutions ("In-house Dark Pools", "Sell Side Dark Pools", "OTC crossing networks"). These market participants are not covered by the current MiFID classification, and as such are not required to provide any pre-trade transparency at all. Similar to the behavior of SI's, data from the reference markets is used as well as a guideline for executions in these sell side dark pools.

### **6.1.2 How is availability affected by these terms and what effect does it have on market participants?**

The view expressed by most respondents is that access to market data generally is satisfactory. Again, references are made to the fact finding on post-trade data, and the fact that pre-trade data and post-trade data normally comes together.

As MiFID has introduced competition, and with it fragmentation of liquidity across several trading venues, the need to virtually consolidate data streams from several venues has arisen. General feed-back to ESME:s last market consultation indicated that regulated markets and MTF's provide good quality data which is broadly made available by those sources at a level playing field at reasonable prices. In contrast, now market feed-back indicates that data from SI's and/or broker/dealer crossing networks seem to be either not available (in the case of crossing networks) or – in case it is made available – in rather poor quality (SI quotes).

Market participants have the choice to either connect to each venue separately, or to use the services of Market Data Vendors / Market Data Aggregators. Various market-led solutions have already been established (providing various forms of consolidated data, as feed or as terminal products) or come under way to virtually consolidate the fragmented data environment. Several data vendors provide a consolidated view of pre- and post-trade information across European markets and lively compete to fill

their customer demands and provide innovative services to their clientele. Examples include, but are not limited to: Bloomberg’s “MDM” (Market Data Monitor) service virtually aggregates order books of regulated markets and MTF’s; Thomson Reuters’ “.xbo” service allows a consolidated Best Bid and Offer, and the “Reuters 3000 Xtra workstation” provides a customized view of top of book and depth of book pricing across trading venues of the users choice. Equiduct’s Orange VBBO provides a nearly identical service.

However, some comments made are that availability to consolidated market data is less developed. Such consolidated data is said to normally be developed and designed for certain user categories, in particular users that have a strong demand to track prevailing prices in real time on all relevant execution venues and who can also afford the higher fees that comes with such service. Example of such users are some buy-side firms, in particular those using algorithm trading and direct market access (DMA) services who have a strong interest in low latency trading. Also, we concur from some responses that sell side firms and indeed also certain execution venues, notably such venues that offer their own SOR-facilities to trading participants, have strong preference for a consolidate tape. These participants can already – depending on their respective needs – subscribe to various product packages, which are offered on the highly competitive market by the aforementioned market data aggregators. In addition, some respondents expressly pointed out that they would not see any reason for, or advantage in, the introduction of a mandatory consolidated tape.

Some respondents also comment that the availability of quotes from SI’s generally is poor and not fit to be consolidated with data from lit trading venues, such as regulated markets and certain multilateral trading facilities (like Chi-X and others). Indeed, many point at the fact that such quotes, in the way they are currently made available, are of less interest from a market transparency point of view, and that the difficulties in getting access to it is of less concern. However, one respondent representing the buy side industry note that the market has become more opaque and in-transparent, and the information content has worsened post-MiFID. Consequently, efforts should be undertaken to increase the overall levels of pre-trade transparency on the market, including those of pre-trade transparency provided by SI’s.

### **6.1.3 ESME:s Position on questions raised under 6.1.1 and 6.1.2.**

Regarding the availability of pre-trade data, the most important issue seems to be the uneven level playing field amongst trading venues with regard to pre-trade transparency requirements. In addition, there seems to be a certain degree of “free riding” on reference market prices by those venues that do not contribute to pre-trade transparent markets, especially by SI’s and sell side dark pools. This uneven level playing field provides systematic incentives for certain investors to keep their orders away from the public price formation process on transparent venues. The ultimate consequence is a further weakening of reference market prices with severe consequences for the overall price formation process.

We conclude that the fees for obtaining pre-trade market data basically are on the same levels as prior to MiFID, and that this conclusion matches the findings we did in

our recently published report on post-trade data. We also reiterate the position expressed in that report, that it certainly is too premature to make a thorough assessment of the developments of such costs because (i) the vast majority of MTF's still apply fee holidays for market data, and (ii) it is still uncertain how many alternative competing execution venues that will survive in the long run due to the enhanced competition and the narrow margins for operating such venues on a profitable basis.

However, one conclusion that can be made is that the fragmentation which has evolved after MiFID has raised the demand for consolidated market data. Access to such sophisticated consolidated market data is provided by market data aggregators, which might come with a higher cost<sup>4</sup>.

There is a major distinction between lit and dark pools of liquidity. Lit pools of liquidity are generally the various regulated markets where the shares are admitted to trading plus the MTF's which compete with such regulated markets.<sup>5</sup> The availability and access to pre-trade data pertaining to such lit pools of liquidity is generally good, and there are a number of service providers that consolidate the fragmented pre-trade order book data, and present it to users as one single aggregated order book such as Reuters, Bloombergs and others. Thus, from a user perspective the access to pre-trade data from regulated markets and lit MTF's appears not to be a main concern (whereas the MiFID intended fragmentation as such might be a concern due to its potential effects on the transaction costs, although market data aggregators are offering services to mitigate this issue in a competitive environment).

The prices for obtaining pre-trade data from regulated markets have virtually been unaffected by MiFID. However, investment firms should – *inter alia* due to the best execution requirements – obtain prices from alternative, competing execution venues as well (notably MTF's). So far, such MTF's – as mentioned in a few responses – have applied fee holidays in order to account for the low market value of their data and for promotional “shop window” purposes.<sup>6</sup> Prices for data from the primary sources remain the same as prior to MiFID because they still provide high value to investors, as they have a high informational content. However, the costs for aggregating the data have increased, whereas this situation provides incentives to market data aggregators to provide innovative services to virtually consolidate the fragmented environment. Therefore, the effect of the market fragmentation has been

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<sup>4</sup> This finding is based on the fact that a prerequisite to produce consolidated market data is to connect to and obtain such data from all relevant execution venues. Since the market data fees remained on basically the same levels as prior to MiFID that could result in higher overall costs for some participants in the industry.

<sup>5</sup> The most predominant MTF's so far is probably Chi-X, Turquoise, Bats Europe and Nasdaq OMX Europe, all established in the UK. From a Nordic perspective, the recently launched MTF Burgundy could be mentioned as a new contender to Nasdaq OMX Nordic.

<sup>6</sup> Low or no market data fees reflect the respective market value of that data. It seems that liquidity posted at the new venues is largely synthetic in nature: liquidity providers base their MTF quotes on liquidity available on the home markets (recent outages on NYSE Euronext and LSE support this thesis, as liquidity on MTF's has virtually diminished during the respective home market outages). Therefore, the informational content of MTF's pre-trade data currently seems to be quite limited – which might result in the observed low (i.e. zero) market prices. In addition, another explanation for MTF data fee holidays is the ‘Shop-Window’ effect: being new venues, MTF's need to present themselves to the market. By displaying market data free of charge, they attract the attention of customers who might be willing to finally connect to and trade at the respective venues.

higher costs for the intermediaries and in the end also to investors (recognizing, though, that many firms only bill for a transaction fee which is “bundled” with other relevant costs and where costs for obtaining market are comparably minor). It can reasonably be assumed that, once the trading volumes pick up at the MTF’s, the informational content of their data will increase, and consequently also market prices of MTF data. Correspondingly, the informational content of data from home markets might decrease. The overall costs for market data may therefore remain constant or increase, depending on the developments. It is also questionable – due to the factors mentioned under Section 6.1.1 – how realistic or practicable true consolidation of market data is, particularly in the absence of mandated common standards.

One of the novelties introduced by MiFID was – as described above – the new transparency regime for SI’s. According to CESR’s website, there are – as of 22 June 2009 – in total 13 execution venues categorized as SI’s. Most of these venues are London-based, and post their pre-trade quotes through the facilities of Markit BOAT or on their own websites. Another two are run by Danish banks, and post the indicative prices on their websites. The reason behind the high representation of Danish intermediaries is probably the concept of “strakshandel”, which is the model for trading in shares that historically has been applied on the Danish market.<sup>7</sup> However, for all SI’s, the quotes are not easily available, and we have not found any evidence that they are ever aggregated with pre-trade data published by regulated markets and some MTF’s described above. Very few market participants seem to pay any interest in SI quotes, basically because they rarely reflect the actual prices at which the SI’s execute their trades. The prohibition against price improvement in respect of the quotes pursuant to MiFID only applies in relation to retail investors, but the clients which de facto get access to trading through the facilities provided by SI’s are normally professional, major institutional investors. For example, the SI’s that use the facilities provided by Markit BOAT have agreed to apply the following Price Improvement Policy:

*“An investment firm who is a Systematic Internaliser (“SI”), may improve the price of orders that are bigger than the size customarily undertaken by a retail investor (in accordance with Article 27 (3) MiFID Level 2) within the spread of published SI price quote.”*

The spread referred to above is published quarterly based on the trades executed during the measurements period.

In this context, it is worth pointing at a potential issue that may have a negative effect on pre-trade transparency over time. As described above, one of the waivers from the pre-trade transparency requirements are in respect of transactions that are large in scale compared to normal market size (“**LIS-transactions**”), see for example Art. 44.2 in MiFID. The thresholds that are applied for determining whether a certain transaction is a LIS-transaction or not are based on the average daily turnover (“**ADT**”) that is calculated by the competent authorities for each share that is admitted to trading on a regulated market. The ADT is calculated annually, and

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<sup>7</sup> In brief, “Strakshandel” means that the firm executes the client order against its own trading book, and then sets off the opposite leg in the market (or with another client with an opposite interest).

published by CESR on its website on or before the first trading day in March every year (Art. 34 in the MiFID Regulation; No 1287/2006).

The statistics that were used as basis for the calculations for the first time (in 2009) was statistics from order book trading at regulated market, i.e. statistics in respect of trading on MTF's and various dark pools were disregarded, which was also the case for negotiated transactions (i.e. transactions effected "on exchange" but outside the order book).

Hence, the trading in the order book at regulated markets was the key – and in fact only – component that was taken into account when the thresholds for LIS-transactions were calculated in 2009. Since such statistics was published for the first time in 2009, it is not possible to compare the actual developments of ADT, but the over all development of order book trading at regulated markets may serve as an indicator, however recognizing that the major drivers for the developments appears to be (i) the overall decrease in trading volumes and (ii) the decrease in the market capitalizations of traded companies (expressed by the percentage year-on-year change of index levels [FTSE100, DAX30, CAC40, MIB30 , OMX] in the last column in the following table), both due to the financial crisis. To take a few examples, based on monthly statistics published by FESE:

<b>Market</b>	<b>1 January 2008 (Turnover (Eurm)</b>	<b>1 January 2009 (Turnover (Eurm)</b>	<b>Variation</b>	<b>Index Variation</b>
LSE	326,469.3	107,038.9	- 67 %	-29%
Deutsche Börse	298,781.8	85,926.2	- 71 %	-37%
Euronext	332,777.0	114,059.0	- 66 %	-39%
Borsa Italiana	124,886.2	37,528.4	- 70 %	-45%
NASDAQ OMX Nordic	103.591.1	38,448.3	- 63 %	-35%

Even though the figures above refer to the monthly aggregate turnover at some of the major European regulated markets – and not to the annual ADT for individual shares – the trend in respect of lower turnovers during the first year after MiFID is obvious. However, the regime set out in the MiFID Regulation envisages that all order executed across the EU should be taken into account when the ADT is to be calculated in the future (see Art. 33.2). It is therefore imperative that a methodology for including order execution as broadly as possible be developed well in advance of the next calculations to be published in 2010.

## **6.2 Developments of waivers from Pre-trade transparency requirements**

### **6.2.1 How are the waivers for pre-trade transparency currently used, and what is the scope for innovation within the existing boundaries?**

The comments made by respondents are fairly split, certainly due to the mixed interests they have. Those representing lit execution venues (regulated markets and MTF's) argue that the current waivers are either too narrow, and that they hamper innovation within existing boundaries, or that they are too lax, and that they undermine the transparency requirements originally intended by MiFID. In unison, they point at the fact that the differences in requirements for regulated markets and MTF's (to which the MiFID waivers apply) compared to requirements for SI's and OTC crossing networks (for which virtually no material pre-trade transparency requirements apply, and hence waivers are irrelevant) is a major concern.

Specific comments made are in respect of

**Waivers Large in Scale (LIS):** the average order sizes on regulated markets have decreased dramatically after MiFID, and hence the thresholds should be decreased accordingly. In addition, the calculations should be made more dynamic and reflect developments in trading volumes, they argue. Some respondents also state that the exemption from the general MiFID pre-trade transparency regime seems to be justified in the case of large orders in order to avoid adverse price movements.

**Waivers based on order type:** The waiver for the iceberg order type is based on evolutionary developments of the consolidated open order book and reaches back to the 1990s, when liquidity was concentrated in one order book per security. Basically, it allowed traders to transact large quantities without an adverse market impact and was widely used. At the time, it was a compromise between the need to conceal larger trading interest from the market while still integrating it into the home market's liquidity pool which ensured the iceberg orders' contribution to price discovery.

Some respondents state that the waiver applicable to iceberg orders in principle is satisfactorily designed. However, one respondent comment that innovation in respect of icebergs orders should be facilitated, for example by recognizing iceberg orders also for aggressive orders and to allow icebergs with zero tips. Other respondents state that the original rationale<sup>8</sup> for the existence of iceberg orders has largely diminished with an increase in fragmentation. In contrast, some market participants argue that iceberg orders are beneficial to the market as a whole because their existence widens choice for investors and addresses their needs towards hiding their trading interests. In

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<sup>8</sup> Today, iceberg orders are still used predominantly on home markets, as they provide sufficient liquidity (in terms of market depth) which enables an effective hiding of these trading interests while still taking part in the public price discovery process. In contrast, new trading venues still lack sufficient depth, and consequently iceberg orders are not used frequently there.

A major reason for the reduced usage of iceberg orders is the increase in the share of algorithmic trading and the implementation of automated trading strategies (e.g., slice and dice), which has led to an overall decrease in average order and trade sizes. In other words, the demand for trading large orders in electronic order books has decreased.

addition, iceberg order functionality allows for liquidity seeking strategies by Smart Order Routers. However, these strategies are much better served when liquidity is publicly displayed as orders can directly be sent to the market providing the best available price instead of searching for it in the dark. In case of un-displayed orders, smart routers have to apply time-consuming pinging strategies across several markets, which eventually increase execution time and uncertainty at the expense of the investors.

It also appears that the minimum thresholds for defining iceberg orders and/or their peak sizes are not uniform across Europe. The following table gives an overview of the required minimum peak sizes across markets. It is noteworthy that the minimum peak sizes of MTF's are significantly smaller than those of regulated markets.

Minimum Peak Size	Regulated Markets					MTFs				
	Xetra	BME	Borsa Italiana	LSE	SIX	BATS Europe	Chi-X	Nasdaq OMX Europe	NYSE Arca Europe	Tq
# Shares	100	250	40% of exchange market size		100	1	1	100	10	1

**Waivers in relation to reference price:** This waiver was originally designed to meet the requirements of operators of crossing networks (e.g., Posit, eCrossnet) that allowed for trading of large sizes avoiding market impact. Today, more and more trading venues emerge to offer trading at reference prices, which is usually the midpoint of the home market (e.g., Nyfix Euro Millennium, Baikal, Chi-X Delta etc.).

Representatives for lit markets are split on this issue; some express a fairly restrictive view that the current limitations (execution at mid point or at the spread) should be kept, or even restricted further. Others, however, argue that the notion of reference price crossing should be extended to capture execution anywhere within the spread (those in favor of this path argue that this would in fact improve the price discovery process as well as put such markets on an equal footing with OTC crossing networks).<sup>9</sup>

The proponents of the reference price waiver argue that this waiver has improved market efficiency and cleared the way for innovative trading services, that it had allowed for price improvement, and that it does not harm the market quality and price discovery as only a limited portion of all orders are executed on these venues. With regard to innovation, these services and concepts have been in place before MiFID, but customer demand was limited (probably because there was no need for services that helped avoiding the extensive pre-trade transparency requirements as mandated by MiFID). These venues also provide price improvement to investors, as they execute orders at the midpoint of the currently available best bid and offer. This is, on one hand, beneficial to every individual investor, but detrimental to the public as more and more orders are shifted from lit to dark venues and overall transparency suffers.

<sup>9</sup> This said, there is some uncertainty as to the boundaries of the reference price waiver, since CESR has yet not expressed any firm view on whether or not execution anywhere in the spread would be acceptable (even though such views might have been expressed by individual competent authorities).

One buy-side representative argues that the current waivers have resulted in more opaque markets, and that waivers and exemptions should be reduced as far as possible.

### **6.2.2 Do the current boundaries for waivers support efficient order execution and price discovery sufficiently well?**

Representatives of lit execution venues argue that the current restrictions on waivers for regulated markets and MTF's drive trading interest from those markets into the dark pools provided by OTC crossing networks. For example, some argue that – due to the decrease in average order sizes – participants can not put large orders (below LIS-size but high compared to average order size) into the trading system without market impact, hence there is an incentive to route such orders to dark pools to mitigate the risk of market impact i.e. increased implicit transaction costs.

Some responses with regard to the waivers are as follows

**Waivers Large in Scale (LIS):** Trade sizes across markets have decreased throughout the recent years. This results in calls for an adaptation of the LIS parameters. On the other hand, calls to decrease the current parameters are consistent with the aim to facilitate the customers' requirements for the non-display of own orders.

**Waivers based on order type:** The iceberg order waiver was originally designed for the interaction of large orders in the consolidated order book. The waiver is currently used by several market venues to circumvent the Large-in-Scale waiver. This is achieved by setting the minimum required displayed unit to one share (in the case of an MTF it was even zero shares (“hidden order”, “zero tip iceberg”) before FSA intervened and stopped this practice), see the table provided in the answer to question 3 (Section 6.2.1). Today, the respective minimum requirements are set in close alignment with the national supervisory authorities. However, these authorities seem to be having a diverging view on the minimum requirements. Therefore, a harmonized procedure regarding the in-lining of these parameters appears to be beneficial.<sup>10</sup>

**Waivers in relation to reference price:** Originally designed for crossing large orders without market impact. The waiver in its current form rewards the hidden posting of orders of any size on a venue that does not contribute to price discovery and thus undermines a necessary condition for the efficient functioning of fragmented markets.

### **6.2.3 ESME:s position on questions raised under 6.2.1 and 6.2.2.**

At the outset, the preferences amongst intermediaries and investors in respect of transparency vary across Europe due to (i) business model of the intermediary, and (ii) categorization of the investor. While retail investors and smaller intermediaries normally would be assumed to have a strong preference for a high degree of

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<sup>10</sup> The recent initiative from CESR may have accommodated this.

transparency, the opposite certainly apply in respect of major institutional investors and global investment firms. Also, preferences are surely split across regions, for example the Nordic countries where most of the market participants (such as banks and investment firms) prefer execution on transparent trading venues, whereas major global firms in general prefer execution with less transparency. Even though we have not had time to gather sufficient evidence, our assessment is that many of those global firms that are operating within Europe execute not less than 30 per cent or more of their volumes in liquid shares at facilities provided by dark pools, either internal pools or through liquidity pools provided by specific execution venues (such as Liquidnet, Posit and others).

Recently, CESR launched a process to coordinate the assessment of waivers in order to achieve a consistent approach across EU. The assessments are made public; the last updated version was issued on 29 June. Briefly, the position from CESR on some of the waivers can be summarized as follows;

**Waivers in relation to reference price:** Waivers are accepted for crossing at the best bid, the best offer or at midpoint. This view is accepted not only in respect of the prevailing situation at a particular market, but also in respect of the European Best Bid and Offer (EBBO), for example where execution takes place at the mid point of the offer registered at one market and the bid registered at another market (if that would be the tightest spread on a EU-wide basis). However, crossings that are based on transaction cost discounts for passive orders compared to aggressive orders are not accepted, because such incentives are viewed as contributing to the price discovery process.<sup>11</sup>

**Order Management Facility Waivers:** Functionalities which display an order at a certain price, but which would facilitate execution against another non-displayed price are not accepted, with reference to that such hidden orders can not “rest” in the order book, which is a condition for the waiver to be granted.

There is clearly a trend that major international market participants have a preference for execution in what has come to be known as “Dark Pools”. This appears currently not to be a major concern from a liquidity point of view, but there is a danger that this development over time might have consequences that is negative from a general market perspective. Firstly, increased interest for trading in dark pools, and higher volumes being directed to such pools, will endanger an efficient price formation

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<sup>11</sup> The accurateness of such an EBBO could be easily questioned at times when trading speed becomes ever more important. Today, the speed of information dissemination is effectively bound by the laws of physics: When trading platforms are geographically dispersed, the additional time that the price information needs to bridge the geographical distance becomes extremely significant. As a rule of thumb, and ideal conditions presumed, the speed of an electrical signal in glass fibre equals approx. 2/3 the speed of light (in practice, the actual speed is much lower due to switching and queuing delays in networks and servers; and the fact that physical lines do not always follow the air-line distance). An instance consolidating dispersed data to form an EBBO will have to cope with this issue: Depending on its relative location to the various trading venues, the consolidated real-time price information will never be accurate. E.g., for the one-way distance London to Frankfurt (approx. 600 km), the price information would travel 3 milliseconds under ideal conditions; in practice double-digit values are more the rule than the exception. The resulting delays are significantly higher than the currently observable sub-millisecond roundtrip times that have become a reality in Europe’s cash equity trading landscape.

process at more transparent regulated markets and MTF's. Secondly, and closely related to the first point, the more restrictive regime that apply for regulated markets and MTF's in respect of pre-trade waivers compared to the requirements that apply for SI's and OTC-execution, may give additional incentives for execution through facilities provided by the latter. This is because an order that is large in size compared to the average order size – but not large enough to qualify as a LIS-order – might not be able to execute at a regulated market or an MTF without unacceptable implicit transaction costs (for example, to put the order in the order book could result in market impact or, alternatively, execution of the order in fragments would result in that the order need to be worked in the market over a longer period of time). Therefore, in-transparent markets provide a strong incentive for investors to refrain from the public price discovery process (transparent markets) and shift more of their volumes to dark venues, e.g. a venue which allows execution at reference prices. On the other hand, every single order executed at external reference prices does hardly contribute to the price formation process and therefore overall price discovery might be weakened. This, in turn, could potentially weaken the quality of the “reference price” over time, at which the crossings are executed. The more orders that are shifted from lit venues to the dark, the weaker the price would get regarded by market participants as a reliable reference price. Consequently, even more orders could shift to the dark venue: A vicious circle could thus be created.

We do not consider the level playing field concern raised by the lit execution venues during the consultation to be an issue per se. However, if the current regime for pre-trade waivers over time will result in that orders be directed for execution at dark pools to such extent that the quality of market data at lit execution venues would be negatively affected, then this clearly might become a major concern. Such development would become a concern also for so called crossing systems, since they have to rely on external market data provided by the primary execution venues for the purposes of crossing orders in their respective systems.

Even though we concur with the concern above, we do not have sufficient evidence to conclude that this as a “problem” at the moment. However, the development needs to be monitored closely, and regulatory intervention might be warranted in case of indications that the quality of public market data becomes materially negatively affected in the future.

With regard to the scope for innovation and the existing boundaries we note that the current waivers prevent the implementation and usage of certain market structure functionalities. To some extent, this might be interpreted as ‘preventing innovation’. But the most important aspect in this context is the protection of transparency, which is a necessary condition for the orderly functioning of fragmented markets, and which should not be sacrificed on the altar of perceived innovation.

### **6.3 Other trading venues than regulated markets, MTF's and SI's**

#### **6.3.1 What are the business models and characteristics of trading venues claimed to offer services similar to multilateral trading facilities and systematic internalisers, but not classified as such?**

Market participants have developed in-house crossing networks (Dark Pools of large sell side firms). These venues are used to cross in-house order flow in a highly efficient manner. It seems like some of these in-house sell side crossing engines are not classified under the usual MiFID classification scheme as regulated market, MTF, or SI. Therefore, they are not obliged to publish pre-trade data, and are not bound by the waivers. These developments might have an adverse impact on the overall price formation, as un-displayed orders withheld in such a sell side dark pool do not contribute to the public price formation process.

The platforms use fast technology to check a match against their own trading book or do client crossing. In both cases, the order goes through the broker-dealer house-internal matching engine. A match is performed making reference to the reference prices, which are produced at – and publicly available from – the home markets, i.e. the exchanges. Only in case no internal matching is possible does the order leave the house for external execution (e.g., to be executed on a third-party dark pool, an MTF, or an exchange).

These venues enable sell side firms to use new technology in such a way that client orders can swiftly and efficiently be pre-matched but without any pre-trade transparency – and thus be withheld from the public price formation process.

It seems that the SEC is currently taking a closer look into these private, electronic trading venues, with the aim to boost transparency. The US regulator seems to recognize that the price distortion which is due to these dark pools is a major concern and detrimental to the overall efficiency of the market.

#### **6.3.2 Does the current categorisation of trading venues contribute sufficiently to efficient order execution and price discovery in relation to these trading venues?**

Respondents generally recognize that there is a need for transparent trading venues as well as internalization by brokers in respect of large orders. However, they point at the fact that *inter alia* developments in technology and the broader use of algorithmic trading have lead to that also orders of smaller sizes now are electronically executed in dark crossing networks provided by broker dealers. Hence, such crossing networks appear to be more like a fourth category of marketplace outside the scope of MiFID.

Some respondents comment that dark pools do not contribute to pre-trade transparency at all, and argue that this should only be justified in respect of large orders.

One consequence of the above, which is pointed at by some respondents, is that orders executed in broker dealer crossing networks may be executed at any price within the reference spread provided by the primary marketplace. However, if a regulated market or an MTF would provide execution of orders based on a waiver, execution would have to take place either at the spread or at the mid-price.<sup>12</sup> In other words, certain order crossed within a crossing network would not have been eligible for a waiver if they had been routed to a regulated market or an MTF.

One respondent argues that there should be a more permissive pre-trade transparency regime for regulated markets and MTF's than for execution with an SI or OTC in order to encourage posting of liquidity at such marketplaces. The reason for such an approach would be to promote an efficient price formation process but would also provide the users with the benefits of market surveillance and access to clearing through a CCP. Also, any broker could opt in to become an MTF and enjoy the benefits of that under such approach.

A number of respondents question the clarity of current definitions of MTF and SI, and view that most crossing networks that today are operated by brokers should be subject to the requirements that apply for MTF's. Most of them also comment that the current pre-trade transparency regime that applies for SI's is inappropriate and should be revisited.

### **6.3.3 ESME:s position on questions raised under 6.3.1 and 6.3.2.**

Initially, it is worth bearing in mind that MiFID requires a high degree of transparency in order to address the potential negative effects of fragmentation. Hence, it is anticipated that the scope for waivers should be rather narrow, and only accepted when justified due to legitimate objectives from a market efficiency point of view. For example, a waiver should be perfectly fine if a particular order would not be able to execute in a transparent environment without negative economic consequences for the investor, whereas the mere wish to be secret about trading intentions should not qualify to make a waiver eligible. This basic assumption has historically been the driver for "up stair trading"-facilities, but it may reasonable be questioned whether it is valid for at least some of the current execution facilities provided under the label of "SI" or "OTC".

The platforms operated under an SI or OTC-regime are automated and multilateral and fulfill the same function in terms of order execution as a regulated market or an MTF (and also have similarities to SI's). They are not subject to the MTF classification for a number of reasons. One of them seems to be that they introduce an element of "discretion" in their order execution systems. According to this particular

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<sup>12</sup> However, we recognize that CESR has yet not commented on this issue in public under its new procedures.

interpretation of the law, MiFID is taken to allow crossing networks not to be MTF's because they are deemed not to be fulfilling one of the conditions of MTF's (and regulated markets): non-discretionary rules.

In our experience, a major cause to the problem is that the reference to “non-discretionary rules” is unclear and not interpreted consistently by competent authorities. This uncertainty creates a substantial amount of ambiguity and gives some flexibility to firms to calibrate their microstructures in order to avoid the MTF-label under MiFID (or to opt in as MTF's if they would have such preference). There is a clear risk that this turns out to become a fairly technical discussion case-by-case on how to construe the notion of an “MTF” rather than approaching the subject from the perspective of what MiFID actually was intended to achieve. This is particularly a concern in respect of crossing networks, for which there clearly is a need to assess whether or not they should be assessed as MTF's based on a common understanding of the specific requirements (such as non-discretionary rules).

This situation is clearly at odds with MiFID and leads to serious consequences for competition and for the market as a whole:

These venues do not need to comply with waivers:

- In fact, these crossing networks are essentially dark pools with no pre-trade transparency requirements to comply with. Unlike the regulated markets and MTF's that have strictly regulated dark functionality, these platforms are completely exempt from the MiFID waivers from transparency. This means that they do not have to fall under the specific cases (large order, reference prices, etc) that are deemed not to undermine the price formation mechanism in the market. Indeed, many of the orders passed through the broker-dealer platforms would not qualify (would be too small) for the large order waiver if the waiver were applied to them.
- Moreover, execution typically takes place within the best bid and offer published by primary markets. This means that, if they were classified as MTF's, these venues would have to publish pre-trade transparency because the reference price waiver as currently applied in the EU does not allow execution anywhere in the spread.<sup>13</sup>

In addition, these venues do not need to fulfill any other trading venue requirements, as the intermediaries operating these platforms are not licensed or supervised as venues, thus not subject to market surveillance or similar duties. These are costly requirements which regulated markets (and more recently MTF's) have to fulfill for the good of the market as a whole.

The consequences for the market as whole include:

- price formation being undermined,
- additional conflicts of interest being created that were not foreseen by MiFID,

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<sup>13</sup> Again, this conclusion is surrounded by some uncertainty, since CESR has yet not commented on it under its new procedures.

- market supervision suffering because a significant part of the market is not subject to the controls expected of trading venues,
- level playing field undermined because these venues can attract significant volumes with no restrictions and subsequently lower costs and greater flexibility than the regulated venues

As a result of the in-transparency, trades executed in sell side dark pools do not have to be marked as such, and therefore are reported together with the usual “OTC” volumes. The following table displays turnovers of lit and OTC markets for selected European indices (DAX 30, FTSE 100, CAC 40).<sup>14</sup> It can easily be seen that the percentage of OTC turnover has increased for all indexes throughout the last year. One likely driver for the OTC volumes is increasing sell side dark pool volume, although this assertion cannot be finally proved – given the current data reporting requirements. A separate reporting for trades executed in sell side dark pools would enhance clarity about volumes executed in these venues.

Monthly Turnovr EUR bn. Single counted		2008						2009				
		Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.
<b>DAX 30</b>	<b>OTC</b>	39.72	36.54	39.86	57.44	24.70	59.83	57.06	40.36	39.37	99.01	101.98
	<b>LIT</b>	162.81	109.32	195.40	235.03	99.08	79.29	81.10	73.48	89.15	87.90	84.03
	<b>OTC %</b>	19.6%	25.1%	16.9%	19.6%	20.0%	43.0%	41.3%	35.5%	30.6%	53.0%	54.8%
<b>FTSE 100</b>	<b>OTC</b>	60.47	49.34	48.86	68.61	34.98	101.37	41.15	37.73	81.31	46.00	63.94
	<b>LIT</b>	246.24	175.02	280.54	263.75	160.43	111.82	128.80	121.21	147.87	129.11	128.18
	<b>OTC %</b>	19.7%	22.0%	14.8%	20.6%	17.9%	47.5%	24.2%	23.7%	35.5%	26.3%	33.3%
<b>CAC 40</b>	<b>OTC</b>	28.85	36.55	34.76	42.62	43.05	45.96	31.46	29.06	31.69	51.37	64.03
	<b>LIT</b>	142.98	101.52	163.54	189.76	100.62	77.79	87.22	81.83	92.53	93.75	92.13
	<b>OTC %</b>	16.8%	26.5%	17.5%	18.3%	30.0%	37.1%	26.5%	26.2%	25.5%	35.4%	41.0%

Legend: LIT stands for Home Market plus certain MTF\*s  
(for DAX: DBAG plus Chi-X, Turquoise, Nasdaq OMX Europe, BATS Europe, NYSE Arca Europe  
for FTSE100 : LSE plus Chi-X, Turquoise, Nasdaq OMX Europe, BATS Europe, NYSE Arca Europe, Equiduct  
for CAC40 : ENX plus Chi-X, Turquoise, Nasdaq OMX Europe, BATS Europe)  
LIT MTF volumes include trades executed in midpoint-matching facilities. These volumes are very minor (e.g., Chi-Delta has executed approx. €700k per day in 2009 Calendar Week 27).  
Other MTF\*s – inter alia, “Agency Dark Pools” – like Nyfix Euro Millennium, ITG Posit, Instinet BlockMatch, are not included, but overall volumes are considered to be relatively limited .

<sup>14</sup> It should though be born in mind that trends indicated by the data may have been exacerbated by the increase in volatility during the second half of 2008 and the reduction in liquidity. It should also be noted that the statistics in the grid is for illustrative purposes only, and that statistics from other sources may provide other figures. As mentioned under Section 7, this variance is certainly due to the complexity in gathering fully accurate figures in respect of OTC-transactions.

OTC includes trades reported by BOAT, Borsa Italia OTC, Budapest OTC, Chi-X OTC, Deutsche Börse OTC, Dublin OTC, Euronext OTC, Ljubljana OTC, London Stock Exchange OTC, OMX OTC, Oslo OTC, PLUS Markets OTC, Stuttgart, Vienna OTC as available on Bloomberg. The data has been compiled by Deutsche Börse.

As a result of the lack of transparency in sell side dark pools, the public price discovery is weakened, as these orders do not reach the public market. Not even the (pre-trade) information on the order reaches the public market. Therefore, the true situation on demand and supply conditions is not available to a broad public; the prices formed on the home markets over time will become less reliable.

It is noteworthy that, as the public price discovery process could be weakened (e.g., as the home market order book depth is lowered – compared to a situation before the rise of sell side dark pools). Thus, it would take less order volume to move stock prices than before. Client orders would then be executed in the dark pools on the basis of these weakened prices. The overall fragmentation of liquidity would aggravate this issue even more. This trend could increase the risk of market price distortions and also the risk of market abuse.

The withholding of orders from the public price discovery process becomes aggravated by the recent trend amongst large sell side firms to inter-link their in-house dark pools, as responding buy side institutions have stated. If an order is not executed within one institution, it is routed to the partnering dark pools. This process completely takes place in the “dark”, whereas only the involved parties receive the order information.

## **7. Conclusions**

The regulatory framework under MiFID has been up and running for almost two years (since 1 November 2007). As developed in some of the previous sections, there have been some substantial adjustments to the new requirements, where the market participants have not only made efforts to become MiFID compliant, but also to seize the new business opportunities provided under the new regime. However, it is an ongoing process, and the developments are certainly still going on at an un-precedent pace. Even though some trends can be identified already by now, it is in our view too premature to draw any conclusions on where the markets are ultimately going. The abolition of concentration rules across Europe has clearly resulted in more fragmented markets. Although a strict pre-trade transparency regime is required to heal the adverse effects of fragmentation, the markets have – as some respondents have pointed out – become more opaque in terms of transparency. More players have evolved providing competition to the incumbent exchanges, but it is not possible to predict whether this is viable in a longer perspective, or to assess what the situation will look like in 5-10 years time. Some of the new market places may not survive in the new highly competitive environment, and it is likely that we will see even more combinations between various market places driven by a wish to gain economies of scale or to provide a full range of execution services to satisfy demands from various groups of investors with different priorities. Due to the above, one should in our view be careful in drawing any firm conclusions as to whether or not MiFID has achieved its intended objectives, because the evolution is far from over.

Yet we think that a few issues are worth to be highlighted with special attention when evaluating the current, fragmented equity trading landscape in Europe:

- the relevance of pre-trade transparency in the context of a dilemma: While investors need transparency as a pre-requisite for sound *price discovery* on fragmented markets, individual investors generally do not prefer to display their orders to others. Acknowledging the framework of this dilemma might be helpful when reconsidering the existing waiver regime.
- It seems that certain categories of market participants do not contribute to pre-trade transparency as initially envisaged when designing the transparency regime. We think that the market quality would benefit if sell side dark pools and SI's generally improve the way they handle their pre-trade transparency regimes.

### Consolidation of market data

A first issue commented upon by many respondents is the demand for consolidated market data due to the increased fragmentation. This issue was also discussed in our previous report on post-trade transparency, as well as in the recently published report by CESR. It is undisputed that the new fragmented environment substantially has increased the demand for consolidated market data across European execution venues for certain user groups. It is equally undisputed that the consolidation of market data is developing satisfactorily in respect of data from lit trading venues, whereas consolidation is lacking in respect of data from SI's and broker dealer dark pools.

On this matter we reiterate our previous position that consolidated market data in respect of data from incumbent exchanges and transparent MTF's seems to develop in a satisfactory manner. Vendors already consolidated such data before the introduction of MiFID and continue to do so due to the increased customer demands, and they do so in a competitive environment which is expected to be beneficial in respect of innovation and cost pressure. However, it should also be recognized that all relevant MTF's today provide their respective market data for free, and there is a question mark as to what will happen when and if that will change. One potential development is that they raise their fees as the value of their market data increase, as well as – in the same token – incumbent exchanges decrease their fees as they decrease in value. Under such scenario, the over all fees from primary market data sources would remain constant due to the inherent value of the over all market data. Another potential development could be that MTF's cease their fee holidays as they attract more trading interest, while the incumbent exchanges keep their respective fee structures on basically the same levels as today. This development is not unlikely because market data is needed from all relevant trading venues no matter the economic value of the data from each of them. In addition to fee developments from primary market data sources, there are also features such as lack of common standards, differences in the level of data quality, costs for technical developments and maintenance etc. that might have consequences in respect of consolidation of market data and the terms for providing it.

We clearly see positive developments in this area, and consider it to be too premature to recommend any specific measures. However, given the increased importance of

consolidated market data, this issue should be kept on the radar screen in order to keep track on developments which might turn into an unsatisfactory direction. It could be sensible to revisit this issue within a reasonable time frame (for example before end of 2011) when the picture may have become clearer.

#### Quality of price discovery and market data

Incumbent exchanges are highly important as venues where price discovery is performed, and consequently as sources for providing high quality reference data, for example to be used by various crossing networks. We do not see any trends that this will change in the near future. Incumbent exchanges as well as transparent MTF's have raised the issue that they are not able to provide their execution services on a level playing field compared with execution through SI's and OTC. This issue is raised both in the general context of pre-trade transparency, but in particular in respect of waivers. The main concern is that differences in respect of such requirements may – over time – give incentives for order flows to be directed to dark pools rather than the transparent execution venues, and that such development at a certain stage could erode the quality of the price discovery process and thus the publicly available market data. One difference that could drive such development is that SI's and broker dealers may design their “waivers” in a more flexible way, and therefore are in a better position to provide innovative functionalities to fit the demands from their clients. Another driver could be the fact that – since the average order sizes have decreased – there is a cushion between order sizes that can be executed in the order book without market impact and the thresholds that makes large orders available for a waiver. Some exchanges argue that the MiFID thresholds that apply for LIS-orders should be decreased due to this development. Because trading participants can not execute such orders in the order book with sufficient speed (or without unacceptable costs) there is currently an incentive to send the order for crossing in a dark pool instead.

We recognize that the lit markets' function of price discovery and the resulting availability of high quality reference data without doubt are in the interest of lit as well as most dark execution venues. This should clearly be a policy issue for the EU at large in order to facilitate well functioning and efficient markets as well as to maintain the competitive position of European equity markets. A development where the quality of market data from the primary markets would become negatively affected would therefore be highly unfortunate. However, the main question is whether or not there is sufficient evidence to draw any conclusions on these matters.

Publicly available statistics from various sources suggests that more than 30 percent of the volumes in European equity trading, for the most liquid shares, are executed in dark pools. For some markets the percentage seems to be even higher on average. Even though the trend seems to be clear, there are some factors that make it difficult to draw any definite conclusions; firstly the lack of sufficient data prior to MiFID makes the comparison uncertain, secondly, the financial turmoil in 2008 was a special situation which question whether the figures from that period are representative, and thirdly, statistics from various sources holding themselves out to provide data in respect of split between lit venues/dark pools vary quite substantially, which again points out the lack of available data originating from OTC venues. Therefore, we conclude that we are not in a position to say clearly that the quality of market data

from primary sources has been negatively affected in a way which could justify regulatory adjustments for the time being.

If the development would turn in a negative direction because of the differences in waiver regimes, then clearly that development might be mitigated by creating a level playing field in respect of waivers. That should preferably be considered in the context of setting the framework for and assessing the legal label of the various execution venues, as we propose below.

#### MTF's, SI's and OTC-execution.

For long, it has been an accepted market practice to execute large orders with less transparency due to fundamental economic considerations. To execute a large order in a public order book based on a protocol for ranking of orders etc. would expose the investor to a number of negative consequences. One of those being that information on trading interests in large orders could be used by others (e.g. through front running) taking advantage of the information and making the market go against the investor behind such order. Another is the potentially higher transaction costs for such orders if they were required to be executed in a public environment (either through market impact, if entered as one lot, or through immediacy cost and opportunity cost, if being worked in the market over a longer period before being filled). This is clearly also a concern from a best execution perspective, if there are investors behind the large order.

The above economic fundamentals have also been the driver behind the waiver regimes set out in MiFID. While the main rule is full transparency, waivers are recognized in order to find an appropriate balance between executions of large as well as smaller sized orders. However, for SI's and trading that takes place OTC, no waivers apply (because of the lack of pre-trade transparency requirements).

Deregulation and technological developments have made it possible to create more efficient processes for in-house executions, and certain forms of internalization have therefore become more like "traditional" marketplaces. Without having assessed in detail the micro structure of each and every in-house execution venue, we share the view that there indeed is an insufficient and unclear understanding on the definition of MTF, which gives some room for optionality depending on the preferences from the operator of the system.

However, it is also important to understand that most processes in today's environment are becoming more and more automated. One consequence of this is that in-house execution that was previously handled by phone or fax, or by open out-cry in an open trading room, today increasingly is done in an automated fashion. The broker crossing process is an automation of existing non-discretionary process increasing efficiency and reducing cost. The effect of making all brokers crossing subject to MTF regulation may however prevent the broker dealer from achieving best execution for his clients where a discretionary process is needed to achieve this. Therefore it should be amended to make an exemption of price transparency requirements where orders are either large in scale or the broker needs to employ his discretion, i.e. where he can deviate from the automated process and determine individually how to interact with the client order.

In our view, the current definition of an MTF is sufficiently designed to capture at least some of the markets that today operate under an OTC label. Some respondents have raised the issue that the potential ambiguity in respect of the interpretation is the reference to that an MTF shall “bring together third-party buying and selling interests.....in accordance with **non-discretionary rules**”. We consider that the reference to “non-discretionary rules” reasonably should be construed to mean that the rules – or protocol – shall apply equally to all investors/participants that have access to the facility. To this end, we do encourage the Commission to clarify the boundaries of the definition (in particular the reference to “non-discretionary rules), followed by increased focus on enforcement where competent authorities assess each system on its own merits.

The UK FSA has provided the following guidance for the purposes of clarifying the meaning of “non-discretionary rules”;

*“For there to be an MTF, the buying and selling of MiFID financial instruments in these systems must be governed by non-discretionary rules in a way that results in contracts. As the rules must be non-discretionary, once orders and quotes are received within the system an MTF operator must have no discretion in determining how they interact. The MTF operator instead must establish rules governing how the system operates and the characteristics of the quotes and orders (for example, their price and time of receipt in the system) that determine the resulting trades.”*

We support this interpretation and strongly recommend that it be applied consistently across competent authorities within the EU.

Once there is a common understanding on how to categorize various execution venues, the appropriateness of the waiver regimes should also be addressed. Even though we recognize that there are split views on the issue as to whether current requirements on waivers should be adjusted to become more narrow or more flexible – also between the various transparent market places – we do feel that any initiative to change or fine-tune the regulatory requirements for waivers should be preceded by a thorough analysis of the potential consequences to the over all market efficiency. We are currently not in a position to give any advice on this issue.

A related issue is the framework set out by MiFID in respect of SI's. Our understanding of the intentions behind the SI requirements is that they originally were designed to accommodate legitimate concerns from investment firms that put their own capital at risk. Our position is that the few SI's that exist are complying with the MiFID requirements in Article 27, even though in some cases only by its letter and not by the spirit. For example, we question whether it was ever thought about that quotes would be provided on as low levels as for one single share. In any event, it is evident that (i) quotes from SI's are complicated to get access to; (ii) such quotes are not possible to consolidate with other published pre-trade data and (iii) the quotes are of little value, because they do normally not reflect the real prices at which SI's execute their trades. Hence, even though we recognize the history behind the SI-regime and the intentions from its originators, we conclude that MiFID has failed to deliver the intended objectives.

Notwithstanding our conclusions in respect of SI-requirements, we do feel that such execution venues should be considered in the context of market transparency. To the extent they appear to operate as a “market place” in an automated fashion based on a standardized protocol for executions, then one way to address this issue could be to include the criteria of “eligibility for automated matching” into the concept of MTF’s. However, that would most likely require the definition of MTF’s in MiFID to be adjusted. We therefore suggest that the reference to “third party interests” be deleted in the definition of an MTF, which then would result in a new adjusted definition as follows:

*‘Multilateral trading facility (MTF)’ means a multilateral system, operated by an investment firm or a market operator, which brings together buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provision of Title II;*

The new definition would make it clear that an MTF could be based on interaction between third party interest as well liquidity provided by the firm itself, either on a market maker basis or due to proprietary trading. The new definition would mean that execution venues where all trades are executed against the investment firms own book might fall under the definition. Also systems where the firm interposes itself between the sellers and buyers would be considered as MTF’s, if all other requirements were met. By this approach, the current SI-regime would be fully replaced by the requirements that today apply for MTF’s, also in respect of the firms own trading interests. The concern about risks in relation to the firms risk exposure would be appropriately addressed by the waivers that may apply in respect of large orders.

## **Annex I – Background and questions from the Commission**

### **Background:**

In the recent report produced by ESME some issues on pre-trade transparency were raised: "During its investigation, ESME identified that there were also issues on pre-trade data, in particular indications that fragmentation was creating difficulties in getting quotes due to a lack of consolidated data and that this, coupled with the increased number of sources, means that the costs to get a sufficiency of data have increased. Additionally, in some instances non-discriminatory access to pre-trade data does not seem to be granted."

In addition two issues have emerged in relation to pre-trade transparency: The first issue is related to the possibility to waive pre-trade transparency obligations. The possibilities provided by MiFID are based on orders considered 'large in scale' (Art. 20 of the implementing regulation), based on market model (Art. 18(1) of the implementing regulation) and based on type of order (Art. 18(2) of the implementing regulation). Two important considerations underlying the current regime are efficient order execution and price discovery. To assess whether these aspects are supported it would be relevant to map the current use of waivers, the scope for innovation within these (what order types and market models might emerge to benefit from them) and the appropriateness of the current boundaries.

The second issue is related to trading venues (other than regulated markets) not categorised as multilateral trading facilities or systematic internalisers. Some market participants claim that a number of trading venues (essentially platforms offering bilateral crossing) fall between these categories and are subsequently not bound by pre-trade transparency obligations. In this context it is relevant to identify and analyse such business models and their impact on trading, in particular whether they contribute sufficiently to efficient order execution and price discovery.

### **Specifically the following questions should be addressed:**

1. Under what terms are pre-trade transparency data in equities currently made available?
2. How is the availability affected by these terms and what effect does it have on market participants?
3. How are the waivers for pre-trade transparency currently used, and what is the scope for innovation within the existing boundaries?
4. Do the current boundaries for waivers support efficient order execution and price discovery sufficiently well?
5. What are the business models and characteristics of trading venues claimed to offer services similar to multilateral trading facilities and systematic internalisers, but not classified as such?
6. Does the current categorisation of trading venues contribute sufficiently to efficient order execution and price discovery in relation to these trading venues?

## **Annex 2 – Members of ESME**

The members of ESME do not represent their respective firms but participate on an individual basis to contribute their expertise and understanding of financial markets to help the Commission understand the potential impact of such issues and the options available to respond to them. ECB and CESR representatives are observers at the meetings of ESME.

Chris Bates - Clifford Chance  
Mats Beckman – SEB\*  
Margaret Chamberlain - Travers Smith\*  
Fabrice Demarigny – Mazars  
Carmine DiNoia – Assonime\*  
John Foyle,\*  
Gianluca Garbi – Dresdner Kleinwort\*  
Wolfgang Gerhardt - Bank Sal. Oppenheim jr. & Cie.  
Jane Hiljkjær Lauridsen - Danske Bank  
John Holland - UBS Investment Bank\*  
Karl-Peter Horstmann - RWE Trading  
Magdalena Jagodzińska - KBC Towarzystwo Funduszy Inwestycyjnych  
Henny Kapteyn - ABP Pension Fund  
David Meagher - AIB Group  
Javier Mendez Llera - BBVA Asset Management  
Roger Müller - Deutsche Börse\*  
Els Ponnet - Fortis Bank  
María Gracia Rubio de Casas - Baker & McKenzie  
Florence Sirel - BNP Paribas  
Pamela Thompson - Eversheds

\* Participants in ESME sub-group on the Pre-trade Data in Equities in the EU

### Annex 3 – Fact Finding – Addressees of questionnaire or consultation on particular issues

In order to gather sufficient evidence as basis for our assessment on pre-trade transparency we have approached the following organizations in order obtain as much external feedback as possible. We circulated the questionnaire to 24 organizations, and received written feedback from 8 of them (4 responses from representatives of transparent market places, 2 responses from vendors, one response from an intermediary and one response from an institutional investor). In addition, we approached certain organizations to discuss specific aspects in respect of pre-trade transparency.

<b>Name of Organisation</b>	<b>Country or Region</b>
ABI (Italian Bankers Association)	IT
Association of German Investment Companies (BVI)	DE
Association of Italian Financial Intermediaries (Assosim)	IT
Association of Private Client Investment Managers (APCIMS)	UK
Bailie Gifford	UK
Baring Asset Management	UK
Bloomberg	EU
Capital Group Companies	UK
CentroSIM	IT
Chi-X	UK
Deutsche Börse	DE
Federation of European Exchanges (FESE)	EU
Fidelity	UK
Futures and Options Association (FOA)	UK
Intesa SanPaolo	IT
Investment Managers Association (IMA)	UK
London Investment Banking Association (LIBA)	UK
Nasdaq OMX Nordic	SE, FI, DK, IS, Baltics
NeoNet	SE
Optiver	NE
Securities Industry and Financial Markets Association (SIFMA)	UK
Swedish Securities Dealers Association (SSDA)	SE
Thames River Capital	UK
Thomson Reuters	EU
T. Rowe Price	UK
Unicredit	IT