

European Commission Public hearing on MiFID review
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Panel III - The changing face of trading - achieving a level playing field for
trading venues and market participants

Initial contribution by John Woodman, Chairman of Chi-X Europe.

“One person’s level playing field is another person’s unfair advantage.

The fact is that people have different skills - and invest in different skills. Equities trading is no different. If I’m a long term investor, I’m going to put a lot of effort into fundamental research. If I’m short term, I’m more interested in the analysis of price movements and the speed of execution - as some people once wanted a booth close to a trading floor, so now some want to co-locate their trading engines with exchange systems. If I’m a retail investor, costs of fundamental research or co-lo systems are beyond me. But I still want to be treated fairly and I know my orders are valuable to others.

So equity markets have different types of investors and the framework of trading systems needs to take that into account. The cost is fragmentation but the benefit is more and cheaper business. Regulations should support such a framework rather than force every investor into one approach: In the 90s we saw the development of electronic Central Limit Order Books as a reaction to competition from the London Stock Exchange; because they were better they won back business and we became seduced by the benefit of centralising order flow but such systems provided a constraint on people who did not want to be forced to split their orders to suit the Central Limit Order Book’s rules. The ability to have different venues to support different requirements of size and time has been one of the main benefits allowed by MiFID.

Let’s step back.

Equity markets are a vital part of the economy; they transfer savings to economic growth. The more efficient they are, the better they serve that purpose. Efficiency certainly isn’t just cost - certainty, reliability, transparency are important, but those things are givens: venues wouldn’t have business without them - but cost is a major factor. And lower cost comes from competition. We’ve seen that in the US over many years and in Europe since the introduction of venues like Chi-X. Trading tariffs have fallen considerably, in many cases by a factor of 10. FTSE 100 spreads are 85% lower today than a decade ago and the average value displayed at bid & offer is up 70%. The CIO of Vanguard, one of the largest global investors, recently said that its transaction costs had declined by more than 50% in the last decade. And research done by my old colleague Benn Steil has shown that the greater the volume the lower the cost of capital for companies. Lower cost leads to more transactions, more liquidity, and a lower cost of capital for companies and lower costs for savers. These benefits have a real value to investors and issuers.

Do these new venues piggy back on existing exchanges: do we cherry pick the cream leaving the old exchanges with the difficult stuff, or do we depend on prices from the old exchanges? I would say not, for three reasons:

First, the growth of MTFs, Dark Pools or whatever has partly been at the expense of legacy exchanges, but they have also grown the total market and therefore overall liquidity by enabling more business to be done. Competitive venues generate business between themselves. New venues are symbiotic not parasitic.

Second, I'm not sure I'd agree that the reference market price belongs to the old exchanges. Yes, they enable price formation but so do we, and in many cases with a larger intra-day market share; but more importantly it is at least as much the users' price as the exchanges. Price formation is more than the build up of orders in a book to give a tradable price. It is also the work done by users before trading and an analysis of post trade information from all venues. But at the moment the old exchanges earn a lot of money from selling that market data. I think you could argue they are piggy backing off the rest of us.

Third, you have to start somewhere. It's not actually that easy to build a successful alternative trading venue. You have to start with a few stocks and a few participants and build out; it takes time to extend the universe both of countries and then stocks. This we have done and we do want to extend further where we can. But if everything had to be done at once competition would not be possible
Market efficiency is not just cost.

Another driver of efficiency is maximising business from different types of user. If I'm a fundamental investor and I want to buy I'm not going to get very far if I can only deal with are other fundamental investors who will mostly want to buy as well. I need people interested in short term price opportunities to sell to me, be they liquidity providers, quant traders, hedging other positions or retail punters. Or capital commitment from a bank. In other words I need liquidity and the wider the range of liquidity providers the better. And because of the connectivity between venues, because of common memberships, I don't necessarily need them on one venue.

Liquidity provision is a benefit to the market: reducing it or impeding it with too many obligations risks the withdrawal of providers at worse, and cost increases to users at best. Over the last few years regulators have removed many of the advantages of being a liquidity provider - largely in the name of creating level playing fields - but fortunately a far more significant driver has stepped in.

Technology. It has enabled new models of liquidity provider who have invested in execution analysis, risk management and the capacity to trade high volume at low cost although many of them are simply doing what they have done as market makers for many years. Firms labelled as high frequency traders - which by the way have different strategies: there is no one High Frequency model - have been able to thrive although the market is already maturing and many high frequency trading strategies are having shorter life spans and becoming less profitable. Some successful high frequency firms are moving into mainstream trading activities and competing head on with traditional banks and brokerage firms. We should

welcome their existence as liquidity providers and not demonise them. Like any trader, they should be free to choose the time horizon of their trading strategy. And they are no more likely to create market abuse or manipulation than other market participants. If there is evidence of market failure in these regards then we should see if existing rules can be used before introducing new ones.

Regulators need to build a greater understanding of how automated trading works, the benefits and risks. However, they should not rush to solutions because there will inevitably be unintended consequences. The majority of respondents to CESR's recent consultation on the MiFID review concluded that further regulations in the area of High Frequency Trading are not required. Many of the issues of the flash crash in the US seemed to stem from market micro structure issues, such as the use of 'at market orders and stub quotes'. Issues of concern like the systematic withdrawal of orders should be regarded as market abuse and dealt with as such rather than an issue of market design. Market micro-structure issues need a regulatory framework which is able to evolve and allows controlled change - the MiFID review should exploit the ability for ESMA to establish that are evidenced based rather than inflexible laws prescribing the smallest details.

If a level playing field means regulators restrict service or price competition by imposing constraints on speed or creating minimum costs to suit lowest common denominator venues, it must be wrong: why would you deliberately stop business or improvements in doing business? Only surely if there is evidence that there was abuse or harm and such evidence does not exist.

But if a level playing field means that exchanges - trading venues - doing similar things should be regulated in a similar way then we are in full agreement and in fact think that MTFs like Chi-X should have the same regime as Regulated Markets. In practice, we already meet the same regulatory demands.

I have painted a Panglossian picture that all progress has been good. But in the case of the equity markets for larger companies post MiFID I think it has: it may not be fashionable to say so, but all this extra business really is socially useful because it lowers the cost of capital and the cost of saving. Just as short selling is a valuable service to reset a false market and of course for people who want to buy.

Natural market adjustments of consolidation and improved handling of fragmentation of venues are levelling playing fields faster than any change in regulation could. The regulatory focus in my view should be on two things, encouraging a more complete and consistent post trade information and cheaper clearing. These would deliver real benefits to investors."

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