

EPFSF Lunch Discussion

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MiFID Implementation

**Speech from Adam Kinsley
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Thank you for the opportunity of speaking at the European Parliament's Financial Services Forum today.

It's not the first time I've spoken here on MiFID. But on previous occasions the debate was all about what the legislation should or shouldn't be.

So, it's of great interest to me to look at how the market has developed today, and compare it to what we were all predicting back in 2003 and 2004 when the Level 1 text was going through the Parliament.

It's also a good opportunity to give some thoughts on what is working well, and what is perhaps working less well.

As a speaker from a stock exchange, I'm going to focus on some of the market facing issues rather than the conduct of business rules or information sharing arrangements between regulators.

One of the main features of MiFID was to introduce greater competition among trading venues, which was welcomed by the exchanges. But it is important to think about what the specific design of the competition policy was intended to yield. The aim was to generate greater efficiency and better and cheaper services for the investors.

So I want to focus on three things.....Market efficiencyMarket transparency.....Investor protection

Let me start with Market Efficiency.

Exchanges have a long and rich history of being neutral and independent venues, bringing together the buying and selling interests of investors in a transparent and safe way.

So will the role of traditional exchanges change? I think the answer to this is no....and yes.

The way exchanges have organised themselves to promote efficiency has developed over time ...I think it is well accepted that European exchanges have been way ahead of their US cousins when it comes to market efficiency.

Whilst at some point all EU exchanges have used trading floors, the last 20 years has seen huge investment in technology systems which are proven at being robust, efficient, fair and most importantly safe. Exchanges invest heavily to ensure they have state of the art surveillance system as market orderliness and investor protection run through the very heart of what exchanges have stood for..... Do I think that will change. Absolutely not.

But will exchanges stand still. No they won't. MiFID has facilitated changes to the way in which trading is arranged. It feels like we are seeing an almost daily declaration of a new venue or MTF, and 'dark liquidity' is all the rage. In EU speak, we are talking about waivers from pre-trade transparency that were negotiated in this very building. I'm not sure that when those discussions were taking place, MEPs realised just how much innovation this would foster. And as groups of investment banks are being set up setting up MTFs to make use of this discretion, the exchanges

are responding. The LSE announced last month that it is to enter this space with its pan European dark pool called Baikal.

However, rather than being nervous, I think its important that policymakers + legislators embrace these changes, and understand why dark pools are becoming fashionable.

As traditional exchanges and users technology have become more efficient, trading spreads have narrowed and trade sizes have become smaller and smaller.

This leaves a problem for the large institutional block business. Initiatives like Baikal are designed to solve this, making the market more efficient. Its about doing what we've always done. making the market more efficient, we're just changing the way we're doing it.

I don't think the fundamental goal of market efficiency will change for traditional exchanges, but they will evolve the way they achieve this

It is probably too early to say what the impact of the investment bank sponsored MTF will be. I do think their governance almost by definition gives them a different philosophy to traditional exchanges. Whether they have the same desire to remove market frictions remains to be seen. Whether they can act in a truly neutral way is also an open question

In judging, how successful they are, we will need to look beyond headline statistics, and ensure that metrics emerge to judge the overall quality of the market

This brings me on to market transparency. I want to touch on pre-trade, the Systematic internaliser regime, post trade and delays for block trades.

I have already mentioned dark pools and waivers for pre-trade transparency. Early feedback seems to be that investors and participants are happy with the way this is emerging.

Onto SI; more Parliamentary hours were probably spent on this, than on any other topic. I think there has been some surprise at how this panned out.

I can recall commentators observing that there would be around 400 Sis across Europe.

However, the CESR lists tell us there are just 8 firms, and they only exist in 4 of the 27 jurisdictions. So no SIs in 23 counties.

This appears counterintuitive with what we know about internalisation and I'm sure says more about that ambiguity in the definitions of Article 27 than representing actual market practice.

I was also quite surprised when I tried to find the SI's pre-trade quotes. In fact, I was only able to find meaningful quotes from one firm when I checked a Bloomberg terminal when I left my office.

The markets seem to be operating OK without this transparency, so I highlight the issue not to advocate pre-trade transparency for Sis but because it was so hotly debated in the Parliament at the time, and MEPs may find the outcome interesting.

Next I want to turn to **post-trade transparency**, as this is an area where we have seen significant market developments.

With the removal of concentration rules and the guarantee of transparency on national exchanges, MiFID introduced general obligations on investment firms to make their trading transparent on a trade by trade basis.

New mechanisms and venues have developed outside of national exchanges to fulfil this obligation, and this has represented a change for the industry.

In certain markets, where there were previously high levels of heavily regulated transparency, notably the UK, the change has led to some teething problems as people get used to the new regime.

In other jurisdictions, such as Germany, Austria and Lux, where trading away from the exchange was completely opaque, the change has brought significant new transparency which is widely welcomed. So the experience is different depending on what you were used to, but it is safe to say that on a European wide basis, we now have a far more harmonised model, and the regime has certainly been positive across the EU. Whilst some in the UK are complaining, I suspect the European model is far superior to the cumbersome prescriptive and unpopular Regulation NMS in the States.

There are provisions in MiFID that introduce delays to the publication of post-trade information, where the underlying trades are large. It was always going to be hard to get these thresholds right. And I think some are now saying some of the delays are excessive for the most liquid stocks. So I'm sure the Commission will be studying this as part of their review process

So finally **investor protection**.

It is easy to forget that a number of provisions in MiFID were designed to protect investors rather than make it easy for participants or exchanges to do business.

In some areas, it may be the case that regulators have been more interested in ensuring that not too much work has come with MiFID implementation, than worry whether the spirit of provisions are being implemented.

Two areas I would pull out, would be the best execution rules, and the Article 22 provision on limit orders.

On best execution, I know firms have informed their clients on their new policies, but often these are so general it fails to give the investors any certainty over where or how the trade will execute.

Part of the regime, is the need for firms to get prior express consent to trade away from regulated markets. Many firms have relied on implicit or tacit consents, or have placed an upfront declaration in their terms and conditions. I'm not sure how regulators have decided this is satisfactory but they seem to have got comfortable.

Second is the requirement to display unexecuted limit orders on public markets. This recognises that a trade can be internalised, but if the internalising firm can't offer an immediate execution, the clients order should be exposed to the market to give it the best chance of executing by interacting with other orders. The directive allows clients to waive their rights, as exposing a large order may not be in the clients interests, but it seems that firms have frequently taken this opt-out and applied it on clients behalf to any limit orders no matter the size.

In short, where the directive says 'may', firms have read this as 'can'. This may not be an issue for the legislator but the national regulators should be taking a principles based approach to compliance looking at the spirit of the directive not just the letter.

So to conclude, MiFID seems to be promoting market innovation, and so market efficiency ought to be enhanced, but we need to look again once all of these new venues are up and running.

We especially need to ensure we don't measure success by simply counting the number of new entrants. Fragmentation has a cost. More is not necessarily better. It could be better but we have to look at market quality.

On transparency, post-trade is bedding down well, and apart from teething problems emerging locally, the regime has enhanced transparency across Europe.

The delays for large trades may need some recalibration

On pre-trade, there have been more use of the waivers than expected, but that's the innovation I talked about.

On SIs, the outcomes have been surprising, but do not seem to have damaged the market.

On investor protection, national regulators need to ensure that they are thinking intelligently about the application and not just ticking boxes.

Overall, it seems that from a market perspective not much has changed yet, but as new MTFs launch, we will need to assess the success of MIFID not just by the number of new entrants, but by the underlying quality of the market that they create.

Thank you

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