

Response to
Call for evidence on the impact of MiFID on secondary markets functioning

Borsa Italiana welcomes the opportunity to submit views on the Call for evidence relating to impact of MiFID on secondary markets functioning.

We appreciate the opportunity to contribute to this important call for evidence and our organization will remain at your disposal for further clarification on the issues raised above.

We report our views following the sequence of the answers pointed out in the consultation document.

- ❖ *Questions 1: what do you think are the key benefits for yourself or the market more generally that have arisen as a result of MiFID provisions relating to equity secondary markets?*

In general we can say that MiFID has increased transparency in some markets (such as those that did not have article 28 like rules before: Austria, Luxembourg, Germany), has increased cross border trading platforms, has added a degree of visibility to how trading relationships work and the differing needs of clients and, last but not least, has harmonised the investor protection rules creating a common framework.

However, the biggest benefit expected from MiFID rules on trading – i.e. more competition leading to better results for the investors (and reduced cost of capital for issuers) – seems not to be so clear at the moment.

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

On this point we believe that the systematic internaliser regime on transparency have created an unlevel playing field for regulated markets and MTFs. In particular, we can consider the following main issues:

1. many firms that are doing what should be considered systematic internalisation are not properly registering as SI. In fact, if we look at the CESR database there are only 13 systematic internalisers registered (at 9 January 2009). In addition, we have recently observed an quick development of crossing networks' activity performed by the main international brokers, like Goldman Sachs SIGMA or Merrill Lynch MLXN that would appear to be doing the business of organised venues

but instead they are operating under the OTC framework, and therefore outside of the pre-trade transparency requirements. On this matter we believe that such platforms take a literal interpretation of the definition of MTF and deliberately structure themselves in such a way that they are not captured by the definition;

2. while the OTC trading evades both SI and MTF classification and the subsequent rules on pre-trade transparency, the pre-trade transparency rules applicable to RMs have proven to be inflexible and inappropriate. This increases the regulatory gap between off-exchange trading and on-exchange trading, and hampers the ability of RMs to innovate and to attract orders from off-exchange.

The overall result is that there is not a level playing field among all the venues. This does not promote a high quality execution environment for the end users and investors. In addition, the above-mentioned issues increase the regulatory gap between off-exchange trading and on-exchange trading and hamper the ability of regulated markets to attract orders from off-exchange.

❖ *Question 3: do you think that MiFID has supported innovation in the equity secondary markets? Please elaborate.*

In general terms it is hard to say whether MiFID has supported innovation, even if we could affirm that the implementation of MiFID discipline represented a sort of “incentive” for the development of new trading venues, such as the rising MTFs and systematic internalisers, focused principally on the trading on shares. In this way the equity secondary market is experiencing a different and a new competition between all the trading venues.

This competition concerns not only possible and different market model microstructures (e.g. new typologies of orders such as mid-price orders) but also the regulatory and commercial sides. For example, some MTF adopted an asymmetric trading pricing, based on the aggressive and passive orders, and some others laid down a market regulation in order to reflect the new MiFID provisions (e.g. possibility to admit to trading customers other than banks and investment firms).

At the same time also the regulated markets took the opportunity of MiFID to modify the market model and/or the Rulebook, but it is worth noting that continuous improvements and developments have been made during the previous years in order to satisfies the customers’ needs and guarantee and orderly and efficient trading.

In addition, the execution time (latency) appears to be an important parameter in the competition between trading venues and further investments to bring it down seem likely. The aim seems to be to attract algorithmic trading and most large trading venues state their latency in the range of slightly less than 1 ms up to 10 ms. The importance on latency is highlighted by the recent investments in IT by some important players.

Judging from the current developments the efforts by trading venues to reduce latency will continue for some time still.

In conclusion, we think that MiFID represents only one of the many causes and aspects that contributed, and contribute, to support innovation and, therefore, it is our opinion that market developments are largely the result of wider factors.

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

We do have faced costs as a result of MiFID such as the updating of the trading system and the rewriting of the Market Rules. Although these costs are important our primary concern now lies more in the overall impact of MiFID on market quality and structure and the evolving dynamic between market players.

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

With regard to any unexpected consequences in terms of level playing field, it is worth noting that the rising MTFs seems to be subject to a more flexible regulation and oversight as to the regulated markets.

In fact, looking broadly at the initial and ongoing requirements on MTFs, the general understanding (including some supervisors) is that MTFs have to comply with lower market surveillance standards compared to those required to market operators. In this situation the costs bore by MTFs are lower than ones faced by the regulated markets, because MTFs focus their activity on trading services and are not requested to carry out functions such as the listing of the financial instruments or the supervision of the companies.

In this way MTFs can be considered as trading venues complementary and/or parasite to the regulated markets as they benefit of positive externalities provided by the above mentioned listing and supervision functions performed by the market operators. A concrete example of this situation has been shown by the fact that, when London Stock Exchange registered an outage of the trading system, nearly no trades has been executed on the competitors MTF.

In addition, also the recent experience regarding the ban of short-selling by European Regulators has unfortunately shown obvious evidence of the lack of coordination and/or cooperation between regulators in those critical circumstances. The fact that the ban of short selling did not apply to the trades executed directly on MTF damaged the level playing field between regulated markets and MTFs, pushing the investment firms to trade on MTFs rather than on regulated markets in order to continue their “*short selling strategies*”.

The ultimate conclusion of this is that the competition between trading venues result in a certain level of market fragmentation with no clear advantages in term of reduced trading costs for final investors considering the increased bid-ask spread (see also the following Q6 answer).

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

Some academic studies demonstrates that an increased competition between equity trading venues, and therefore an increase of the venues in which it is possible to execute the same financial instrument, can bring to a more fragmented market. In this sense one of the principal effect is represented by an increase of the average bid-ask spreads of the trading book, thus increasing the implicit trading costs. On this point it is worth noting that the implicit costs represent a very big part of the total cost to trade.

With regard to the explicit costs (principally represented by the trading fees) it seems that increased competition between equity trading venues is having the effect to modify and/or reduce the trading price schemes in order to better reflect, for example, new trading technicalities (e.g. development of algo-trading).

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

As anticipated in relation to question 6, in theory the existence of several trading venues could bring to a more fragmentation of trading and liquidity. Therefore, as a general consideration a higher fragmentation of the trading may damage the price discovery and price formation process, principally due to the fact that the bid-ask spreads are wider and the depth of the trading book is lower.

As said in the Question 6 the above fragmentation can bring to higher implicit trading costs and can increase the difficulties of the intermediaries in reaching the best execution. In fact, with the new MiFID provisions the investment firms shall take all reasonable steps to obtain, when executing orders, the best possible result for their clients. Moreover, where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration (price of the financial instrument and the costs related to the execution).

Clearly, if a financial instrument is negotiated on more than one trading venue the intermediaries, for the purpose of delivering best execution, should assess and compare the “performance” of the various trading venues in order to identify the best venues to be included in its execution policy. Furthermore, the same intermediaries shall monitor

the effectiveness of their order execution policy in order to identify and correct any deficiencies and, at least annually, shall review their execution policies to verify the firm's ability to continue to obtain the best possible result for the execution.

Last but not the least the investment firms shall have to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy.

All the above-mentioned requirements are simple to fulfil in case of execution policy with one trading venue but are complex, and sometimes impossible to fully fulfil, whenever there are five, six or more trading venues that potentially are to be considered by the intermediaries. In this last case, it could be necessary investments in IT and/or internal complex procedures in order to be compliant with the MiFID provisions.

Anyway, with regard to the execution of trades in Italian shares, the market data and market share seems to indicate that, at the moment, there is not a shift of liquidity from the regulated market MTA (managed by Borsa Italiana) to other trading venues.

- ❖ *Question 8: do you think that MiFID pre- and post-trade transparency requirements adequately mitigate potential concerns arising from market fragmentation?*

On this point we would like to underline that, from a regulatory point of view, MiFID transparency requirements mitigate potential concerns arising from market fragmentation only partially. In fact, the regime provides that the information must be made public using one of the alternative channels: i) the facilities of a regulated markets or an MTF ii) the facilities of a third party iii) proprietary arrangements. Therefore, there are in theory hundreds of information sources to be collected.

Anyway, we are not aware of any widespread problem with European pre-trade and post-trade data dissemination. In fact, there are a range of solutions, provided by many vendors, to aggregate and disseminate market data, based on market-led demand. Therefore, the market seems to be functioning well, especially regarding the post-trade transparency.

- ❖ *Question 9: is the categorisation of shares appropriate in relation to: the definition of liquid shares; 'standard market size'; 'orders large in scale'; and 'deferred publication'? If not, please elaborate.*

In general we consider appropriate the current categorisation of shares in relation to the MiFID requirements. However, there is an issue which may warrant further examination by CESR. In detail, the deferred publication rules around large trades have effectively been relaxed which has led to the possibility of large trade reports being excluded from same day trading volumes. This issue could create confusion for users of the data. Therefore, whilst we agree it is right for certain trades to be able to utilise the delay, it would be desirable for CESR to review whether the definition is functioning as it was intended.

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

As general consideration it is worth observing that the term "dark pool" is not defined under MiFID. In general terms, it seems that a dark pool of liquidity may be considered a trading facility where orders are not publicly displayed for the purposes of pre-trade transparency obligations, based on the relevant waivers provided by MIFID.

Some trading venues have put special emphasis on the use of dark orders to attract large orders and, probably, avoid the market impact that these orders could have on the trading book. Therefore, we could affirm that, in general, the "dark pool facility" should bring some benefits to the entire market but, at the same time, could damage the level of pre-trade transparency, useful to understand the characteristics of the entire bid and offer curves.

Anyway, we believe the pre-trade transparency rules applicable to RMs/MTFs have proven to be inflexible and inappropriate. This increases the regulatory gap between off-exchange trading and on-exchange trading, and hampers the ability of RMs to innovate and to attract orders from off-exchange.

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

The trends towards an overall increase in dark liquidity in Europe does raise interesting and important policy questions for regulators. The overall objectives of exchanges has always been to provide "clear, fair, transparent" markets. Policy makers may question the extent to which MiFID has started a trend away from this, encouraging trading on to OTC platforms where there is no pre-trade transparency (and indeed dark pools run by exchanges and MTFs). This may raise systemic concerns for the market, which policy makers may wish to explore.

- ❖ *Question 12: do you consider the MiFID pre- and post-trade transparency regime is working effectively? If not, why not?*

On this point we would like to underline the MiFID transparency requirements is working effectively only partially. In fact, the regime provided is applicable only to the shares admitted to a EU regulated market, leaving outside the scope all the other financial instruments that are quite important like the corporate and government bonds or the ETF. In this sense it is worth noting that the Italian regulator (CONSOB) extended the post-trade transparency requirements to financial instruments other than shares admitted to an Italian regulated market but, on the basis of our information, the majority of the Member states did not extend the transparency regime and also the final report of the European Commission (April 2008) expressed in this sense.

On this point, therefore, we call for a more extended transparency regime, also considering the recent financial crisis and with the objective to assure a more harmonised approach in the EU. For further considerations on this issue please refer to answers to Question 2.

- ❖ *Question 13: what MiFID pre- and post-trade transparency data do you use, and for what purpose? Does the available data meet your needs and the needs of the market in general?*

On this point it is worth noting that we are a provider rather than a user of data, therefore we cannot comment on whether the available data meet your needs and the needs of the market in general.

- ❖ *Question 14: do you think that MiFID pre- and post-trade transparency data is of sufficient quality? If not, please elaborate why and how you think it could be improved.*

Following the introduction of MiFID, concern has grown around the quality of market data available. More in detail, it is possible to identify 4 principal issues:

- over-reporting: investment banks are unsure of their obligations and are over reporting to ensure that they are compliant with MiFID. This causes a duplication of trades across one, or more, trade reporting platform. Incentives may also exist that encourage firms to over-report for reasons associated with market share payment for order flow and their own financial stakes in particular venues.
- data quality: some trade reporting platforms appear to apply poor quality control checks before publishing data to the market.
- lack of standardization: some trade reporting platforms publish multiple currencies for a particular security which poses significant problems for data vendors.
- timeliness: MiFID publication rules around large trades have effectively been relaxed which has led to the possibility of large trade reports being excluded from same day trading volumes.

Anyway, industry participants are already working out the data quality issues and therefore a market-driven solution seems to be the most appropriate.

To assess the quality and completeness of post trade transparency data it could also be useful to compare the information made available for post trade transparency purposes with the information reported by investment firms to competent Authorities in order to comply with transaction reporting information.

- ❖ *Question 15: do you think that there has been significant fragmentation of market data in the EEA equity markets? If so, please elaborate. Do you think that such fragmentation raises concerns (for example, does it impact on the*

price formation process, the overall efficiency of the markets, search costs)? If so, please elaborate on those concerns.

We sympathise with concern that has arisen over the quality of data reported across different publishing entities and the problems this has caused for any (vendor) solutions based on aggregating this data.

However, this is part of the bedding in process for MiFID and we do not believe any further regulatory intervention is required. Market pressure should be sufficient to rectify this issue. In addition, the London Stock Exchange Group is actively working with other interested participants from across the market to find market-led ways to deliver consistent higher quality post-trade data, which can then be aggregated, disseminated and used with increased confidence.

❖ *Question 16: does the current availability of data facilitate best execution? If not, please elaborate.*

On the basis of our experience we believe that best execution regime is working well and, therefore, no further action should seem necessary at EU level. In fact, we can state that:

- setting up a European Market system infrastructure would be hugely costly;
- the advantage of the best execution regimes currently drafted is that it takes into account many factors (and not only the price). In contrast, a US-style “trade-through rule” seems to be overly simplistic (it focuses only on price and ignores important factors such as market impact);
- in a fragmented environment market impact costs become more not less significant and, therefore, the best execution regime should not exclude them.

❖ *Question 17: do you think that commercial forces provide effective consolidation of data? If not, please elaborate.*

Yes, vendors such as Proquote, Fidessa and Bloomberg already produce effective consolidation. The problems so far have been with the quality of the data that is being transmitted to the vendors (i.e. “rubbish in, rubbish out”). Once the market data quality issue is remedied via market-led initiatives (see answers to Question 14), this will provide an efficient solution.

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

Competition amongst trading venues has increased but the important question is whether the end investors have benefit from this and whether the cost of capital has reduced. We have had difficulty finding evidence that this has happened.

❖ *Question 19: do you see any other impact or consequence of MiFID on equity secondary markets functioning?*

We see no further impacts and consequences of MiFID than those set out in our previous answers.

Milan, 19 December 2008