



Deutsche Börse Group

Deutsche Börse's Response  
to  
CESR  
Call for Evidence

on the impact of MiFID  
on secondary markets functioning

Frankfurt / Main, 13 January 2009

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## Executive Summary

Deutsche Börse Group welcomes the opportunity to respond to CESR's Call for Evidence on the impact of MiFID on secondary markets functioning.

MiFID was aimed at establishing a level playing field among execution venues, delivering market integrity and enhancing market transparency, while ensuring a maximum level of investor protection. Although, taking into account the time span between the transposition of MiFID within the EU and today is rather short in order to provide final conclusions and, furthermore, has been and still is exposed to extraordinary market conditions, it seems that MiFID has not yet achieved all of its targeted goals. MiFID has definitely fostered competition, however, market transparency - with regard to off-exchange pre-trade transparency in particular – still has room for improvement as well as the goal of market integrity. Against the background of the current market environment, especially the latter two are of major importance in order to further grow and develop European capital markets and therefore should be the main targets of further activities.

In general, Deutsche Börse welcomes the increase in competition at EU level with (a) the advent of several new trading venues, (b) the set-up of EU wide consolidated views of the overall equity market activities by various market data vendors and other third party providers, and (c) the implementation of execution policies within investment firms, just to mention a few results.

Although Deutsche Börse acknowledges there are still shortcomings with regard to the actual transposition of MiFID in form of national particularities EU wide, we are confident that they can be solved within the existing regulatory framework provided by MiFID. In this call for evidence we provide examples of shortcomings of the national transposition which hinders the establishment of a true level playing field for trading venues within Europe, due to different approaches by various competent authorities and the differences in national law. Apart from the shortcomings which we elaborate on later in this paper, there are also other aspects of differences in market practices and legal systems within the EU Member States that may hinder a level playing field. It appears that different settlement cycles, different tax systems, different insolvency laws as well as different supervision by the various national competent authorities neither provide for a level playing field nor for a fully harmonized capital market within the EU, which cannot be remedied by MiFID, but which is likely to be harmonized by other ongoing convergence processes (e.g. removal of Giovannini barriers).

In addition, Deutsche Börse would like to take the opportunity to take a stand as well towards recent discussions regarding the implementation of US-like regulation in Europe. Certain groups of market participants start calling for the introduction of a US-like consolidated tape and for the implementation of a best execution requirement on an order by order basis. We strongly believe that the European market structure and market integrity

requires a different regulatory framework than that established in the US and that the current MiFID regime is a solid basis to achieve a competitive environment that conveys comprehensive investor protection, efficient market structure and sustainable market integrity. From our perspective, any dilution of the current MiFID regulation by introducing Reg NMS into Europe through the back-door would run contrary to many of the initial targets of MiFID like competition including innovation, as various studies account for.

Against this background, we very much welcome this CESR call for evidence and are looking forward to the results of the upcoming MiFID review of the European Commission due in 2010.

### Brief summary of Deutsche Börse's key messages

#### 1) Key message with regard to level playing field:

We observe trends that deviate from the overall stated MiFID goal of a level playing field among execution venues:

- Ø There are considerable differences in supervisory practices of competent authorities across Europe. In order to ensure a truly level playing field it is necessary that competent authorities align their supervisory practices more closely. As an example, it needs to be stated that some Multilateral Trading Facilities (MTFs) were able to offer certain order types in a fashion ("hidden order") that was not compliant with MiFID.
- Ø Along the equity trading value chain, safe and efficient post-trade services play an important role. Whilst additional competition in the clearing space is beneficial in terms of providing additional choice for market participants, it is vital for the integrity and stability of the equity markets in Europe that such competition is not performed at the cost of quality and standards in risk management.

#### 2) Key message with regard to fragmentation:

- Ø We argue that fragmentation might threaten existing market liquidity and that current technological advances such as Smart Order Routing do not overcome these threats and in fact may increase costs for the whole industry.

#### 3) Key message with regard to trading costs:

- Ø Taking both explicit and implicit components of trading costs into account, the total trading costs for an investor went up: decreases in explicit costs seem to be offset by increases in implicit or indirect costs (i.e. need to consider full transaction costs and not only price).

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4) Key message with regard to transparency:

- Ø In general, the quality of pre- and post-trade data seems to be very good, especially when provided by a Regulated Market (RM). OTC pre- and post-trade transparency, however, seems to have several areas where the quality does not live up to the quality of information delivered by a RM. This should be able to be overcome, however, with the introduction of Best Practice approaches and/or stricter controls of investment firms transparency duties by the relevant competent authorities.
- Ø Current availability of market data facilitates best execution requirements according to MiFID.
- Ø Commercial forces provide for an effective consolidation of market data – e.g. new market data sources which have entered the European market have announced to form an initiative in order to simplify the consolidation of their market data. This clearly shows that market forces and competition in the area of market data work as intended by MiFID.
- Ø Consolidated data views / feeds are made available by various market data vendors, e.g. Bloomberg and Reuters as well as other third parties, e.g. Fidessa, thus overcoming market data fragmentation – although the time span between now and the introduction of MiFID has been relatively short.
- Ø Furthermore, we argue that implementing a consolidated tape is not applicable in the European context with its various national differences. It counters the original intentions of MiFID and its approach of principle based best execution.

Please find below our detailed remarks to selected questions related to the above statements.

## Detailed Remarks

### On downsides of MiFID

#### 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.*

#### 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 the introduction of MiFID various measures have been taken to introduce and/or enhance competition. However, it appears that interpretation of certain MiFID provisions differs from Member State to Member State, so that such approach may result in an unlevel playing field. In the following, a number of examples are given which illustrate recent trends of deviation from a level playing field.

#### 1. Regulatory Arbitrage / Supervisory practices of competent authorities

In order to establish a true European-wide competition it is necessary to ensure that no commercial competitive advantage arises based on the choice of the respective regulatory authority and legal framework within Europe. It is obvious that these issues need to be addressed accordingly.

Until most recently, Chi-X used to offer a hidden order implementation which was not MiFID compliant. This hidden order was fully non-displayed (price and size) and not subject to order size restrictions (i.e. "large in size" which is permitted by MiFID) while still interacting with the open limit order book of Chi-X. Even though Chi-X started trading in 2006, it took until August 15th, 2008 that Chi-X finally announced to make adjustments to its hidden orders. The announced changes were implemented not before September 22nd, 2008. It took quite a significant amount of time until Chi-X stopped offering this order type. From a Deutsche Börse perspective, it is difficult to explain this long period while Chi-X was able to offer such a hidden order type.

Hence, it is crucial that the responsible Competent Authority reduces its response time to such obvious offences, so that market competitors may not deliberately choose the strategy of regulatory arbitrage.

## 2. Post-trade Services: Central Counter Party Risk Levels & Level Playing Field

Along the equity trading value chain, safe and efficient post-trade services play an important role. One possible service offering is clearing through a Central Counter Party (CCP). A CCP takes over the counterparty risk arising between trading members. In that role, a CCP is capable of managing and controlling counterparty risk more efficiently, compared to any single trading member. With the rise of new trading facilities, also new CCPs have been implemented.

Whilst additional competition in the clearing space is beneficial in terms of providing additional choice for market participants, it is vital for the integrity and stability of the equity markets in Europe that competition in the clearing space is not performed at the cost of quality and standards in risk management. Events during recent financial markets turmoil have demonstrated that the structural setup of a clearing house and its risk management mechanisms are of utter importance. For the clearing house to be able to serve as key element of stability in the financial markets value chain, neutral governance has to be in place. This avoids effects of potential information asymmetries and enables the clearing house to define the risk standards required to ensure the integrity of the market. In terms of risk management capabilities, effective intraday risk management controls have to be in place to cater for growing intraday volatility. A “race to the bottom” in terms of lowering risk standards out of competitive motivations (avoiding margin costs for members/ avoiding investment costs into risk management systems of the clearing houses) cannot be accepted.

MiFID targets to protect the interests of the investor. Safety and integrity of the post-trading market structure thus needs to be promoted as a prime goal.

### On trading costs

#### 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.*

On the one hand, increased competition by new MTFs with aggressive market entry strategies caused lower explicit trading costs.

On the other hand, competition caused fragmentation of liquidity. While our experiences with DAX® stocks traded on Xetra®, the electronic trading system of the Frankfurter Wertpapierbörse, do not suggest any noticeable negative impact on implicit costs so far, the average spread observed on new MTFs in the respective instruments is significantly larger

compared with its primary market. Evaluating the venues separately, this observation would directly translate into increased overall trading costs for investors - as the reduction of explicit costs does by far not compensate for the on average increased spreads.

A Smart Order Routing effectively combining the order books of trading venues and taking explicit trading costs into account is assumed to (partially) offset the negative effects on implicit costs (see Question 8), but empirical analysis to prove this thesis is not available so far. In addition, connectivity costs as well as the creation and implementation of Smart Order Routing may increase cost for the industry as a whole.

#### On potential fragmentation

Question 8:

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

In general, Deutsche Börse sees pre- and post-trade transparency requirements adequately mitigating potential concerns arising from fragmentation regarding market data distribution. However, we still observe negative effects of fragmentation which must be constantly monitored and managed accordingly. One typical example for such a potentially negative effect is described in the following.

#### Insufficiency of Smart Order Routing Technology

Usually, it is argued that the benefits of order flow fragmentation outweigh the potential costs of fragmentation. One of the main reasons for that is the upcoming technology of Smart Order Routing (SOR). This technology is capable of monitoring numerous markets and route orders based on an execution policy. Thus, investors can place their trading decision on a consolidated set of information and spread orders across markets. This argument holds true for investors seeking immediate liquidity by placing market orders. However, SOR technology fails in overcoming costs of fragmentation in regard to placing limit orders.

The fundamental short-coming of SOR technology is that it cannot consolidate order books properly in respect of time priority of passive orders. An example to illustrate this point: In a world with one consolidated order book two buy limit orders with the same price are usually executed according to the time priority (first in / first out – principle). However, in a world with multiple open limit order books strict time priority may be bypassed by choosing an alternative trading venue. This has the following implication for a liquidity provider: A liquidity provider who posted the older order is harmed, because the probability of execution decreases even though he exposed her view on the market first. Thus, liquidity providers in general have to consider an additional cost of opportunity. They face the risk of exceptional

large decrease of probability of execution as somebody else bypasses them on a different trading platform. This in turn has the following implications: (a) decrease of incentives to post passive orders and (b) decrease overall liquidity and market efficiency. Thus, fragmentation might threaten existing market liquidity despite current technological advances.

### On transparency

#### Question 12:

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

Although the time span between the transition to MiFID within all EU Member States and today has been relatively short, the following observations can be made:

- § Data is mostly made available by Investment Firms, MTFs and Regulated Markets as required by MiFID.
- § As demand for data of newly established MTFs is rather low, these MTFs intend to support consolidation of their new data sources onto Market Data Vendor screens by providing a normalised data feed.
- § Market Data Vendors and other third parties provide consolidated views of pre-and post-trade transparency.
- § Data is generally made available at reasonable commercial terms (or even free of charge, with only one UK third party provider charging at rather high commercial terms).

Besides of these rather positive results, minor shortcomings had been experienced as well:

- § Choice of post-trade transparency service provider has initially resulted in fragmented post-trade data in the UK and in over-reporting by certain investment firms via a new service provider (probably due to wrongly set incentives by the third party service provider). After competent authorities (FSA) intervention, Best Practice has been installed which seems to have reduced double-reporting substantially.

In a nutshell, it looks like the transposition of pre- and post-trade transparency requirements laid down in MiFID has been working relatively well within this short time span. New initiatives, like the announcement of a harmonised feed by the new MTFs show that competition – as intended by MiFID – works as well within the Market Data industry. In case of experienced double reporting the problem seems to be strongly reduced. Furthermore, we

expect that the currently remaining minor shortcomings will be solved by market forces as well as additional regulatory inspection within the near future.

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.*

In general the quality of most pre- and post-trade reports seems to be very good, especially when provided by a RM. Data provided by RMs is of highest quality due to clear established rules as well as the respective investments in relevant technical infrastructure. OTC pre- and post-trade transparency, however, seems to have several areas where the quality of OTC trade data does not live up to the quality of information delivered by a RM:

- § Quality of OTC post-trade information is kept at a minimum but all in line with the requirements established within MiFID which has been discussed in length before the introduction of MiFID. Trade data can be delayed up to 3 trading days, and instead of the execution venue the acronym “OTC” is published together with the trade data.
- § Quality of submitted trade reports seems to have mainly lacked quality due to double/over-reporting mainly by a service provider within the UK (wrong incentive structure). After the intervention of the relevant competent authority and support of a RM a best practice has been installed. It seems that this has already supported data quality.

Quality of OTC trade data could be improved by a clear unified definition amongst competent authorities at EU level (this could be a task for CESR) regarding which trade within a trading chain has to be reported. An exact definition of which trades need to be trade reported according to MiFID still seems to remain unclear.

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.*

Deutsche Börse believes that the currently experienced “data fragmentation” (meaning data being available from various sources) does not negatively impact the price formation process, or the overall efficiency of the European market.

In paragraph A. we will point out the reasons why we believe that data fragmentation does not impact the price formation process negatively and in paragraph B. we explain why a consolidated tape similar to the US, and often quoted within the press, is an inferior and not applicable solution for the European capital market.

#### A. Fragmentation of Market Data

With introduction of MiFID additional execution venues and therewith additional data sources have entered the market as intended by MiFID. However, although the time span between the introduction of MiFID in all Member States and today has been relatively short, data consolidation has been realized to a remarkable extent.

With regard to the price formation process, as stated above Deutsche Börse does not think that the currently experienced data fragmentation negatively impacts the price formation process. This is due to the following reasons:

- § Fragmented data is consolidated via Market Data Vendor terminals or other third party providers.
- § Price formation takes largely place on incumbent exchanges, due to sufficient liquidity.
- § Incumbent exchanges are the reference market for MTFs and OTC trades, and RMs market data are widely available.

With regard to search cost, and taking into account the points mentioned above, it is noteworthy that most of the new MTFs like Chi-X, Turquoise and others currently publish market data free of charge (fee holiday) as they do not provide a value per se, but rather act as a marketing tool. Some of the above mentioned MTFs, however, have already indicated that they intend to introduce data fees in future if market forces allow for it.

As MiFID was aimed at opening the market for competition within a regulated environment, there indeed has been a competitive effect with regard to the market data industry as well. This is in contrast to the regulatory regime in the US, where Reg NMS makes access to all equity market data mandatory, based on the different best execution requirements as compared to MiFID. As a result competition is taken out of the (equity) Market Data industry in the US by law.

## B. Impact of a Consolidated Tape

Comparing the European MiFID with Reg NMS in the US shows that both regulations differ vastly in respect of pre- and post trade transparency requirements as well as other requirements which are inter-related.

Dedicated Plans exist within the US which aggregate pre- and post-trade data across all relevant trading venues in respective pre- and post-trade data consolidated tapes. This is enforced by regulation. Access to the overall set of data is mandatory by law, as it is legally tied to a best execution rule ("on a trade by trade basis") which focuses on the trading price only, in combination with a Trade-Through-Rule. (In this context, it is noteworthy that the US capital market has a very different structure compared to the EU market, where market structure is historically grown and still has to cope with various national differences which make a best execution according to Reg NMS rather impossible.) One of the effects of Reg NMS is that this way competition is taken out of the (equity) market data industry by regulation and market data fees cannot react to competitive forces as they do in the EU. However, this way innovation in the market data industry is impeded as well.

Within the EU the situation with regard to market data is a different one:

- Market data in the EU is an industry of its own, which is subject to competition. This is in accordance with MiFID (including the definition of Best Execution within MiFID).
- Market data fees are subject to competitive pressures as well
- Competition and commercial pressures lead to continuous innovation with regard to the diversity of needs from data users (market participants), as well as constant improvement of data quality.
- Competition as well has led to the swift consolidation of pre- and post-trade data within the EU within a relatively short time frame, thereby taking care of different client needs (e.g. consolidated terminal views, or consolidated direct data feeds)

Equity market participants have different needs with regard to market data, e.g. in terms of depth, latency and technical availability. Whereas long-term oriented retail investors usually require rather basic information regarding price levels usually via internet, high sophisticated short-term oriented arbitrageurs usually require ultra-low latency (usually in co-location close to the respective electronic market places) access to vast amounts of data (e.g. unnetted, unpulsed data) in order to conduct their business. Both extremes of investors provide liquidity and thus play an important role within an efficient capital market. An introduction of a mandated consolidated tape would be counterproductive to market participants and a step backwards to current offerings. Customers orientation and innovation would be stopped and transparency decreased.

Taking into account that a plethora of consolidated data products already is made available and is constantly improved, the introduction of a mandated consolidated tape is – if at all – considerable in combination with the introduction of the best execution requirements as defined within the US. Reducing the best execution multi-parameter definition used in the EU to a price only orientated definition, however, would be inferior to the current MiFID regulation as the financial crisis recently has shown. During the recent financial market turmoil settlement certainty and counterparty risk have become the most relevant factors in the provision of best execution.

In a nutshell:

The mandatory introduction of a consolidated tape in the EU would have substantial impact for the financial industry. A “one-size fits all consolidated tape” would initially lead to an inefficient duplication of services and finally to a limitation of competition with the result that innovation would be impeded.

We are convinced that the competitive market data environment within the EU seems to be superior to the “monopolistic” plan model within the US, which represents as well the risk of a “single point of failure”<sup>1</sup> Various models of data consolidation have been discussed as well in the US, however, due to the “best execution” requirements of Reg NMS, the current model had been established, although it is not regarded as a panacea either. There is already a significant number of academic studies<sup>2</sup> challenging the current best execution regime in the US. They argue that best execution is not only defined by price. Furthermore, they point out that the current regime actually hinders efficient competition.

To conclude, the introduction of consolidated tape in Europe, using a regulatory approach similar to the US, is not applicable due to many reasons. We believe that a principle best execution policy in line with MiFID is most appropriate in Europe, while enforcing a consolidated tape is not a viable option either. Reg NMS including the consolidated tape runs exactly against the original intentions of MiFID including its approach of principle based best execution.

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<sup>1</sup> “OPRA sneezes, Exchanges get the hiccups”, Inside Market Data, 2008-01-28 Vol 23 No 17.

<sup>2</sup> See among other: Blume, Marshall E. (2007): Competition and Fragmentation in the Equity Markets: The Effects of Regulation NMS, Working Paper No. 02-07, Wharton School. Davis, Paul L. /Schwartz, Robert A. (2005): Comments on SEC Reg NMS: The Trade-Through Rule: Re: Release No. 34-50870; File No. S7-10-04, <http://faculty.baruch.cuny.edu/rschwartz/SEC%20Comment%20Letter%5B1%5D.pdf>, O'Hara, Maureen (2004): Searching for a New Center: U.S. Securities Markets in Transition, in: Federal Reserve Bank of Atlanta Economic Review, Fourth Quarter, pp.37-52., Stoll, Hans R. (2001): Market Fragmentation, in: Financial Analyst Journal, Iss. July/August, pp. 15-18.

Question 16:

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

Deutsche Börse closely follows the recent market discussions with regard to liquidity fragmentation tied to best execution requirements implemented within MiFID. Unfortunately, we are often confronted with rather superficial statements. Often best execution requirements implemented by MiFID are misquoted as the reason why market participants would need to have access to low-latency market data from all market places on a pan-European level, or as the reason why market participants need to have access to Direct Market Feeds.

Both statements are misleading as indeed they lack the legal requirements within Europe as already explained above. In Europe, best execution requirements have been installed as a principle-based rule rather than a “trade by trade” requirement, compared to Reg NMS in the US. In order to comply with MiFID’s execution policies in Europe, Investment Firms have to establish and implement an order execution policy which includes information on the different venues used for execution of client orders as well as the factors affecting the Investment Firms choice.

Furthermore, compared to the best execution requirements in the US which are based only on the price of the instrument, best execution as defined within MiFID is based on multiple variables, e.g. price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. This more flexible approach allows for better investor protection with regard to the divergent needs and goals of investors.

Thus, in order to comply with MiFID’s execution policies, it is not mandatory for market participants to have access to low-latency market data for all European markets. MiFID requires that Investment Firms define and review their execution policy at least once a year. In order to do so, Investment Firms can either use best execution analytics as provided free of charge by Deutsche Börse, or at the due date Investment firms can derive their own analytics (information from different venues) from market data provided by the various market places. In order for an Investment Firm to define its execution policy, historical market data are usually used in order to derive the relevant analytics.

Finally, in order to comply with defined execution policies, Investment Firms need access to the respective markets for execution (including technical accessibility of data as well as execution services). Whenever market participants are directly connected to a trading platform, they are provided with the relevant access to this market’s data as well.

Question 17:

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

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*elaborate.*

Unlike in the US where Reg NMS requires mandatory access to all trading data, thus taking competitive forces out of the (equity) market data industry by regulation, the set-up of MiFID does not foresee anything like this within the EU. In fact it is therefore that commercial forces can work efficiently in the EU as well within the market data industry.

Evidence, that commercial forces do provide effective consolidation of equity market data within the EU is given only one year after the introduction of MiFID although the time span has been rather short, taking into account the enormous efforts and long technical development cycles usually experienced in the market data and trading environment:

- § Consolidated views are available via major market data vendors
- § MTFs currently provide their data for free (fee holiday) in order to stipulate demand.
- § Solution providers like Quant House, Wombat, Fixnetix and Activ make data feeds from multiple sources available in consolidated formats.

MTFs announced that they formed an initiative to provide data of their new markets in unified format in order to support Market Data Vendors to technically integrate “new” market data sources (which is currently of low commercial value to the market) more easily. The recently established MTFs within Europe provide a very good example of how competitive forces work within the Market Data Industry. Most of the MTFs like Chi-X, Turquoise and others currently publish market data free of charge<sup>3</sup>, as they do not provide a value per se, but rather act as a marketing tool until the respective market might succeed to build up critical liquidity. Unless this data is made available for free, market participants would not be interested to subscribe to it. Some of the above mentioned MTFs, however, have already indicated that they would intend to introduce data fees in the future, if market forces allow for it, meaning in case they might have been able to attract the critical liquidity.

#### Closing remark

We are grateful for having the opportunity to share our views on the impact of MiFID on secondary markets functioning and remain at CESR’s disposal for further discussion of our argumentation above.

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<sup>3</sup> See „Chi-X to waive market data charges“ in Inside Market Data, Vol 22 No 11, December 4th 2006, and “Burgundy preps free Scandinavian Data”, Inside Market Data, Vol 24 No2, October 6<sup>th</sup>, 2008, and “BATS readies European Data Feed Plans”, Inside Market Data, Vol 23 No 28, April 14<sup>th</sup> 2008, and “Turquoise to waive Data Fees at Launch”, Inside Market Data, Vol 23 No 15, January 14<sup>th</sup> 2008.