In the loop

Pablo Garmon, European business development manager, TAG (Transaction Auditing Group, Inc.) Europe shares his view of MiFID II in the light of the EC Consultation paper versus MEP, *Kay Swinburne's* Report.

The European Commission launched the MiFID review process with its consultation paper on December 8th. The main objective for the regulators is to have an integrated market structure that is well balanced, perfectly piloted, and ensures investor protection. MiFID introduced competition, the main consequence of which was fragmentation, but it also caused some uncertainty about trade reporting and the appearance of new liquidity pools on the dark side. The trading landscape has changed significantly since the 2007 regulations came into effect, with key events such as the Lehman and subprime crisis, but technology has also moved on, especially in regard to the speed of trading, so a reassessment of the regulations is due.

At almost exactly the same time, a paper from ECON (European Parliament's Committee on Economic and Monetary Affairs) - an own initiative report, led by Welsh MEP Kay Swinburne, is addressing four main areas: Dark pools, post-trade data quality, the creation of a consolidated tape and the supervision of multi-lateral trading facilities (MTFs).

Both initiatives share the same objective, but from a different perspective: Swinburne's report concentrates on proposing concrete ideas that need to be undertaken, while the consultation paper is a more of an open initiative, asking its audience for alternative answers from more than 140 questions. While MiFID's main target was investor protection, MiFID2 looks to have two main foci: investor protection and systemic risk reduction. It is perhaps too early to say in which order.

Let's look at the following issues: Market structure, Pre and Post trade transparency, Data consolidation, Derivatives, Transaction reporting and Investor Protection.

MARKET STRUCTURE

- The EC wants to widen the scope of the new market structure by adopting a new approach which includes new instruments, new trading bodies and new governance rules that prevent undesirable behaviour from participants, or - even better - that will impose a process for some trading activities to evolve into a more regulated framework.
- Enlarging the scope of supervision by introducing the definition of financial instruments being "admitted to trading". This will open the spectrum of instruments like DR, ETF, ETC, Certificates and some OTC derivatives (structured products).
- OTF – Organized Trading Facility – In attempt to cope with trading activities outside the three current types of trading venues (RM, MTF, SI), the regulator suggests this new, exclusive category or "Organized Trading Facility". Broker Crossing systems or Interdealer broker systems could potentially become OTFs. OTFs will exclude pure OTC trading (i.e. bilateral trades carried out on an ad hoc basis between counterparties and not under any organized facility or system). The EC consultation paper then converges with Swinburne's report on the suitability of those OTFs to become MTFs, after reaching some asset-specific threshold.
- Dark Pools – Price improvement, no information leakage, block trading, more IOI, natural and non-natural liquidity. At TAG we analyze several types of dark venues, according different criteria; one of those is the size of the trades. Based on our numbers, excluding Liquidnet and Pipeline, all major Dark Pools where we analyze order flow, we found their average trade size (ATS) is only 10% higher than the lit venues, suggesting a paradox with the one main objectives of dark pools - dealing with large blocks. Of course, these apparent small trade sizes could also be the consequence of 'slice and dice' algorithms. The buyside is the biggest user of dark pools but is also the most demanding for transparency.
- BCNs (Broker Crossing Network) are a response to a certain brokers' activity to catch specific clients order flow. What we believe to be new is the automation of such tasks and also the increase in turnover of such venues. As they attract significant liquidity and participate on the price formation (discovery or hiding) mechanism, they must be registered, regulated and supervised as well as other venues, whether they are lit or dark.

Addressing the crossing activities conducted by brokers, the regulator wants to suggest a sub regime of OTF. Evolution of such activities can follow two paths depending on who is entering orders, and against who those orders are crossed and to mandate that those crossing systems become a MTF (if orders are entered not only by the sponsor but also by any third party) or a SI (*if a broker executes client orders against its own proprietary capital*).

- Automated trading HFT – High-frequency trading would be considered a sub-category of automated trading. Automated trading is defined as trading using computer algorithms to determine any or all aspects of the execution of the trade such as the timing, quantity and price. Firms involved in automated trading will have to follow new organizational requirements like risk control measures, capital adequacy and reporting of computer algorithms they have developed, including an explanation of its design, purpose and functioning.
- Market surveillance – Realign and reinforce organizational and market surveillance requirements for RMs, MTFs and OTFs. The exchanges main difference with MTFs is their capital raising capabilities. On the secondary markets exchanges and MTF fight for trades. The main difference today is that MTFs are pan-European, while most primary markets still focus on their local market. That said, regarding trading capabilities, they play the same role, so they must be gauged by the same rules. It appears the regulators would like MTFs' supervision tasks be similar to RMs' ones, especially when an MTF reaches certain level of market share.
- SME – small & medium caps. As competition rages on blue chips, there is a need to help these stocks attract more investors.

PRE AND POST TRADE DATA QUALITY

Granularity – information must be available at the trade level, not per stock per day. Due to several bodies and rules, it is still hard to have a full vision of what has been traded on a single stock in the seconds after the trade happens. Reasons for this include the absence of agreed standards of reporting mechanisms.

Post-trade data quality is directly linked with transparency. A trade is valuable information for the next trade so it improves pre-trade analysis. A VWAP (volume average weighted price) including OTC volumes can be significantly different than the lit VWAP only. We have always said that granularity and speed on reported trades brings transparency and thus improves competition.

DATA CONSOLIDATION – CONSOLIDATED TAPE

After proposing the improvement of the quality of raw data the objective is to ensure that data is provided in a consistent format, by nominating a new actor, APA (Approved Publication Arrangement) in order to provide much more detail and clarity about both the content and format of trade reports. Another objective is to reduce the cost of the post trade data for investors, mandating unbundling of real time and delayed data, freeing the cost after 15 minutes, and finally defining a reasonable cost.

In regards to the consolidated tape, the Commission proposes three alternatives: a non-for-profit organization, as in the USA; a single commercial entity; or a multiple actors with commercial interest and different solutions. Of course, only post-trade consolidated data is considered. One could argue about the cost and suitability of real time tape to let the market open for all tenders.

TAG has suggested it would be best to follow the US model, adapted of course to European market organization. The main reproaches are the revenue sharing pricing formula and the (low) speed of the data. Our vision is that a consolidated tape was implied in MiFID's initial objectives, but 3 years on, no real market initiative – other than the major data provider's offerings - is available, so we welcome NYSE Technologies proposal and we would be prepared to bet that this could show the way to other tenders allowing more competition. We could end up with several tapes, in which case one might ask how to choose between them, but we'd say let's the regulator provide the guidelines first.

COMMODITY DERIVATIVES, TRANSACTION REPORTING AND INVESTOR PROTECTION.

We see these three topics as new initiatives or amendments to clarify current grey areas.

We all think these issues are complex. While French Finance Minister Christine Lagarde called for more strict supervision, Alexander Justham, director of markets at the UK's FSA, sees nothing urgent. Our view is that statements must be based on very solid analysis provided by independent sources, and validated by the market. Based on our (humble) knowledge, we see little proof of HFT's impact on the quality of liquidity. Our conjecture is that some additional academic work will be brought to the table just after the Commission starts its consultation process.

Regulators must also ensure that the price formation process will remain consistent. There are two reasons for this; first a lot of trades are done on 'imported' prices, and second due to the increase of technical glitches, end users must have the guarantee that trading on alternatives venues will not have a hidden cost.

In conclusion we congratulate the US and Europe regulators that have already started a joint collaboration. It may not be the same market, nor the same vision, but the same participants and the same objectives. Further to a recent meeting between Mary Schapiro, SEC Chairman and the CESR, we welcome that regulators are currently developing new and wide-ranging rules designed to address regulatory concerns including OTC derivatives, credit rating agencies, hedge and private equity funds but also sharing views regarding market structure issues and systemic risk, among others. ●