The MARKETS in FINANCIAL INSTRUMENTS DIRECTIVE (MiFID):

MULTIPLE TRADING VENUES and BEST EXECUTION

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INTRODUCTION

- **MiFID is a path-breaking set of rules and a cornerstone of EU FSAP to create a single EU market in financial services**

- **Goals:**
  - **drive down the cost of capital**
  - **generate growth and boost Europe's competitiveness**
  - **contribute to the employment and growth goals set by the Lisbon Strategy**

- **This will be achieved by means of:**
  - **removing obstacles to the use of *single passport* by investment firms**
  - **fostering competition and a level playing field between EU trading venues**
  - **ensuring a high level of protection for investors across Europe**

- **Anticipated benefits:**
  - **increased competition,**
  - **greater transparency**
  - **enhanced investor protection**
  - **significant deregulation as super-equivalent national measures are cut back**
  - **more effective regulatory co-operation.**

INTRODUCTION (Cont.)

- **Consistent implementation across EU Member-States:**
- **Set Core Directive 2004/39/EC**

  Sets the core elements of investment firms and markets regulation

- **Set Implementing Directive 2006/73/EC**

  Enables the implementing provisions on organizational requirements and operating conditions for investment firms to be *flexibly adjusted* to the specificities of the particular national market/legal systems

  However Member-States are prevented from going beyond the requirements set out in the implementing Directive *except in certain exceptional circumstances*, where specific risks to investor protection or to market integrity or to stability of he financial system have not been adequately addressed by the Community legislation.

- **Set Implementing Regulation 1287/2006**

  Harmonizes across Member-States record-keeping obligations for investment firms, technical definitions of covered derivative contracts, transaction reporting, market transparency, admission of financial instruments to trading.

- **Authorize European Commission to monitor implementation (L4)**

BEST EXECUTION 1

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The notion of Best Execution

- **According MiFID L1, Article 21: "***Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.*
- Thus, the concept of "**Best Execution**" is transformed: it moves away from the traditional simple "**best price**" (lowest bid, highest offer) towards "**best possible outcome at lowest possible costs**".

Best Execution Policy. Investment firms must:

- **have a Best Execution Policy,** explaining the factors the firm will consider when executing orders and providing information about the 'execution venues' to be used for each financial instrument;
- **inform clients** about its execution policy and obtain their consent;
- **assess the execution venues** in its execution policy at least annually and consider including other execution venues;
- **monitor the effectiveness** of its execution arrangements; and,
- **should be able to show** (upon request, both to the client and the regulator) **that a client's order has been executed in line with the firm's execution policy.**

BEST EXECUTION 2

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A three-step approach in establishing Best Execution

- *First,* depending on the nature of the clients and their needs, an investment firm should **decide which factors affecting the result of execution should be given priority** for clients generally or for particular groups of clients.
- *Secondly*, investment firms should analyze available execution venues in order to **identify those venues that will enable it to obtain the best possible result**, and take the necessary steps to execute its client orders in those venues.
- *Thirdly,* an investment firm should **establish criteria to choose the trading venue** to place the trade. Guidelines to establish these criteria are: (a) price; (b) likelihood of the trade having a successful outcome; and (c) overall costs. In other words, essentially: *quote, liquidity* and *fees.*

Account must be taken of different investor needs

- MiFID recognizes basically **three types of clients**: (a) retail, (b) professional, and (c) eligible counter-party.
- **Retail clients** are the ones requiring *most* best execution assurance from the investor protection point of view, based on **total consideration** of price and cost (art. 24(1))
- **Professional clients** are assumed to be sophisticated enough to be able to evaluate best execution on their own, without broker assistance.
- **Eligible counter-party** is the most sophisticated (presumably not requiring best execution clauses).

TRADING VENUES 1

Regulated Markets (RMs)

- MiFID L1, Art 4 (14) states: "*Regulated Market' means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments..*."
- Art. 36-47 set terms for authorization of RMs and require that RMs … *have clear and transparent rules regarding the admission of financial instruments to trading* (art. 40).
- RMs are the only place where financial instruments can be admitted to trading, thus retaining exclusivity in setting admission standards, and in monitoring prospectuses, corporate trade and financial disclosures as well as market abuse, provided they are allocated the proper authority.

Multilateral Trading facilities (MTFs)

- Art 4 (15) states: "*A Multilateral Trading Facility (MTF) means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third- party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules …".*
- MTFs brings together multiple parties interested in buying and selling financial instruments and enables them to do so. These systems can be crossing networks or matching engines operated by an investment firm or a market operator.
- MTFs exclude bilateral systems. MTF transactions are not (?) subject to Prospectus or MAD provisions

Systematic Internalizers (SIs)

- Art 4 (7) states: "*Systematic internaliser' means an investment firm which on an organised, frequent and systematic basis, deals on its own account by executing client orders outside a regulated market or an MTF*."
- An investment firm can be an SI on one specific instrument only. Transparency requirements apply for (liquid) shares only under Standard Market Size.

TRADING VENUES 2

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Consequences

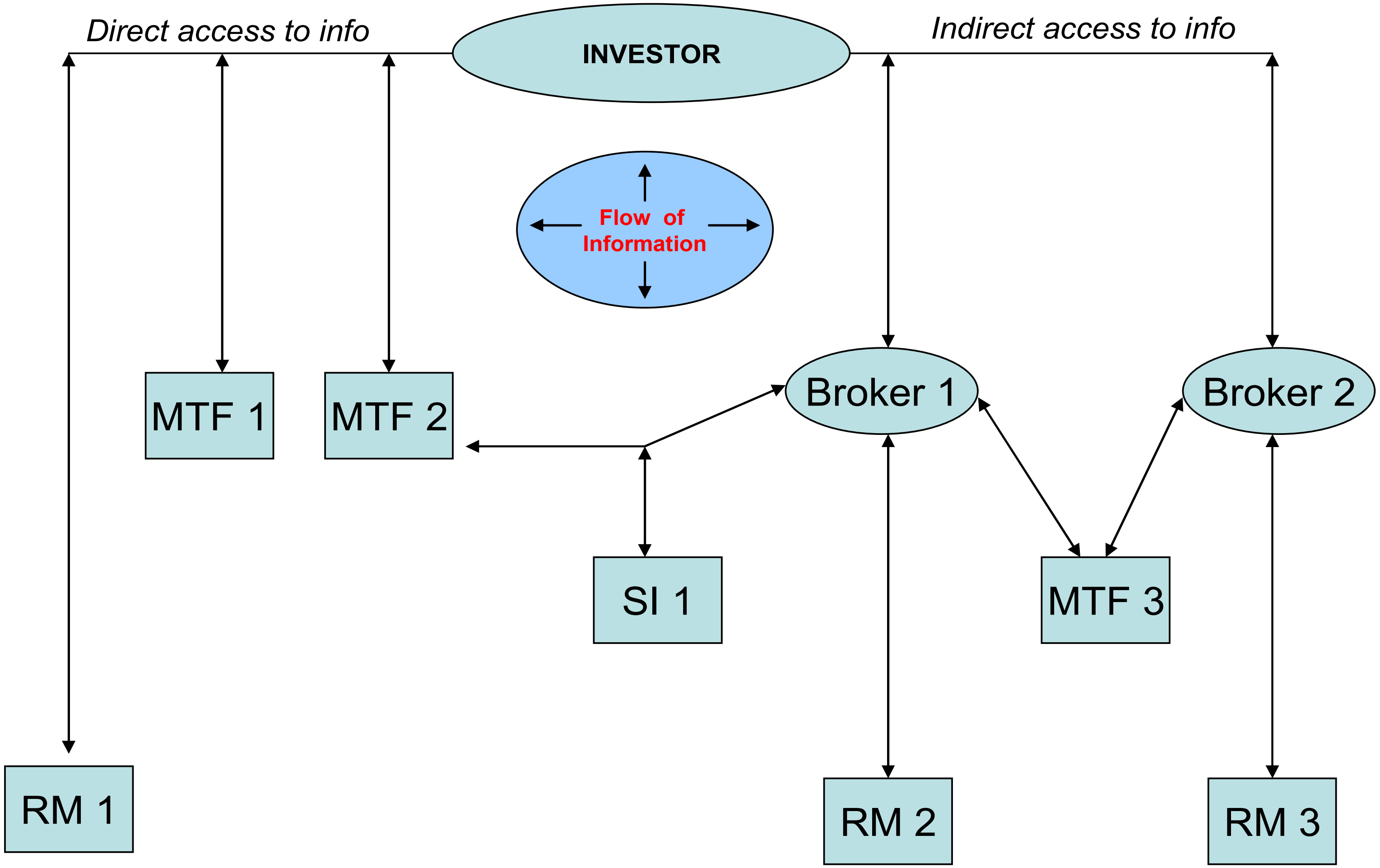
- There will be no regulated exchange with a 'de facto' monopoly of trading for a certain financial instrument in a certain jurisdiction.
- Pan-European competition will bring down the cost of trading.
- It will be easier to trade in instruments listed in other countries within the EU. This will expand the 'liquidity pool' of most instruments and should make life easier for investors.

Trading venues and best execution

- For trades executed on Regulated Markets, best execution will depend on the choice of the operating exchange.
- For trades executed on a MTF, it is usually the case that an executed trade is best for either client, but not both.
- For trades executed through Systematic Internalization, where the broker is himself acting as a counter-party to his client, best execution is an inherent conflict between maximizing profit for the broker and the best deal for the client.
- Finally, for trades executed on an OTC market, best execution evaluation is especially difficult and will critically depend on the choice of execution venue.

TRADING ON MORE VENUES

RM = regulated market **MTF** = multilateral trading facility **SI** = systematic internaliser



VENUE SELECTION AND BEST EXEC 1

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Liquidity

- Liquidity is the likelihood for a trade to reach successful completion in a reasonable time. Liquidity is inferred from the **transparency reports** provided by trading venue.
- Investment firms must **consolidate information from various sources**, either by establishing internal info production systems or resorting to external data vendors.
- Traders expect **quick indication** of which trading venue is most liquid. This requires collection of data, sorting of venues in order of liquidity and providing rapid, continuously updated information to traders as to the most liquid venue for the trade.

Cost

- Investor's final price in a 'Buy' trade is the Quote plus the Unit Cost, whilst in a 'Sell' trade is the reverse: Quote minus Unit Cost. Costs are both internal and external.
- Cost information is gathered from **pre-** and **post-trade transparency reports**, so the connection between investment firm and trading venue should be uninterrupted. Latency between *time of change* of data and *time of change availability* to the front office is critical. Investment firms must establish IT systems that **minimize latency** for every financial instrument traded, and any possible venue where it may trade.
- The difficulty in calculating indirect (external) costs and the likelihood of latency in data collection and processing may create **market fragmentation**.
- EU regulators (i.e. FSA) disclosed proposals for the creation of **Trade Monitoring Mechanisms** to validate and facilitate the consolidation of fragmented information

VENUE SELECTION AND BEST EXEC 2

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Venue selection

- A constant and dynamic process.
- MiFID specifically states that the list of trading venues has to be reviewed regularly.

Guidelines for venue selection

- **Availability of market data**: Unless an investment firm has a substantial and dedicated IT resource, it is unlikely to be viable (in terms of time or cost) to include market data outside of that already supplied by existing vendors or services.
- **Liquidity**: A guiding principles of Best Execution is the "likelihood of a successful trade". Illiquid venues make trades less likely and hence these should be low priority.
- **Ease of execution**: Availability of electronic trading, similar trading hours, differences in time zone and anything that may facilitate trades or minimize possibility of errors.
- **Costs/inducements**: The price (or quote) is naturally a key element in the process. Equally, any inducements will become part of the execution price and will have to be assessed against competing venues for the best mix of quote/cost.

Venue selection and choice of investment firm

- Investor's choice of broker is advised to follow the same criteria for choice of venue
- Investors should ideally select brokers that provide trading reports to the regulator
- Investor dealing OTC through a broker need to establish who reports their trades.

TRANSPARENCY REPORTS 1

Pre-trade transparency

- RMs and MTFs must disclose a pre-trade information with certain detail for every share traded in their systems.
- Pre–trade transparency obligations of RMs and MTFs vary according to the trading system. **Continuous order-driven systems** must disclose the five (5) best bid & offer prices, showing aggregate orders and number of shares at each price level. **Continuous quote-driven systems** must disclose two-way quotes for each market-makers, showing prices and volumes. **Periodic Auction Systems** must disclose the price at which the system would best satisfy its trading algorithm and the volume that would potentially be executable at that price. **Other systems** must disclose as appropriate to the nature of the system.
- SIs must disclose pre-trade transparency for each liquid share for which they are an SI. Pre-trade transparency obligations for SIs imply disclosing a firm quote (or quotes) up to a **Standard Market Size** for all liquid shares for which they are an SI:
- SI Quotes (a) can be one-sided, but they must include size and price, (b) must be disclosed in real time, and (c) be all included in disclosed records to be maintained for a minimum period of 12 months.

TRANSPARENCY REPORTS 2

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Post-trade transparency

- Post-trade transparency includes **any share** admitted to trading in any EU RM.
- Post-trade information shall include **mandatory fields** for (a) trading day and time, (b) instrument identification, (c) unit price, (d) price notation, (e) quantity, (f) venue identification, (g) others.
- Post-trade information must be made public **as close to real time as possible** and at **most** within 3 min past the trade. Special arrangements apply to portfolio transactions
- RMs, MTFs, SIs and investment firms trading OTC must follow certain **guidelines** when disclosing pre-trade and post-trade information:

  - All reasonable steps must be taken to ensure that the disclosed information is reliable; monitoring it continuously for errors and correcting these upon detection;
  - Data consolidation with similar data from other sources must be facilitated; and
  - Information must be made available to the public on a non-discriminatory, commercial basis at reasonable cost.
- When a transaction is executed outside an RM or an MTF, one of the investment firms shall, by parties agreement, arrange **to disclose information** (in order of priority):

  (a) The firm that sells the instrument concerned, or

  (b) The firm that acts on behalf of or arranges the transaction for the seller; or

  (c) The firm that acts on behalf of or arranges the transaction for the buyer; or

  (d) The firm that buys the share concerned.

IMPLEMENTATION ISSUES

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Data (collection, aggregation, dissemination)

- Fragmentation necessitates comprehensive and accurate consolidation of data. Firms are advised to review data suppliers, assessing their accuracy, coverage and latency
- Even if existing data suppliers already carry out some consolidation, the traders of an investment firm need consistent, detailed information across all instruments
- MiFID in terms of the multiplicity of trading venues, creates new classes of Reference Data; all investment firms must conduct an overall review across all Reference Data.

Systems and processes

- Multiple venues generate multiple quotes and execution possibilities. Front office systems must include this info and the possibility of selecting trade execution venues.
- The level of IT upgrading needed is specific to firm's systems. Firms must ensure that any trade information processed will always carry the venue identification code.
- Eventually, the EU will witness the creation of many market operators (MTFs, Data Aggregation Mechanisms, SIs). The overall operational and technology structure of firms must have sufficient capacity and flexibility to include them as they occur.

Contractual reviews with data supplies and investors

- Investors must ensure that both Best Execution Policies (the investor's and the broker's) are consistent
- Firms will have to review contracts with both clients and data suppliers.

CONCLUSION

- The transition towards the new regime brought about by MiFID implementation need to be carefully managed. There are substantial conceptual differences and significant practical implications to consider.
- The end of Concentration Rules means that RMs will cease to have a monopoly of trading in one jurisdiction;
- The changes in Best Execution away from simply best price towards best possible result at lowest possible cost will favor those trading venues that enable institutions to achieve compliance by facilitating easier, cheaper execution of trades, together with an incentive to attract liquidity in order to boost trading volumes.
- This will demand execution systems to be redesigned in order to integrate directly with the front office and the provision of data to vendors willing and able to collect and collate the information.
- MiFID represents an opportunity for firms to consider how they wish to conduct business across Europe in the future and offers a chance to create an integrated, highly efficient business model to deliver maximum business advantage.

THANK YOU!