

# Changes in the Regulatory and Trading Environments for European Stock Markets

October 2012

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# Agenda

- European regulation process overview
- Overview of regulation proposals impacting trading
- Impact on European securities markets

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# EU regulation pipeline

- Number of EU regulations currently in the pipeline and are expected to be enforced during 2013-2015 including:
  - Markets in Financial Instruments Directive/Regulation (MiFID II/MIFIR)
  - Market Abuse Directive/Regulation (MAD II/MAR)
  - European Market Infrastructure Regulation (EMIR)
  - Short-selling Regulation
  - Central Securities Depositories (CSD) Legislation
  - Capital Requirements Directive (CRD) IV

# EU regulation process

- Trialogue process – consists of submissions and voting from three bodies:
  - European Commission
  - European Parliament's ECON (Economic and Monetary Affairs) Committee
  - European Council's ECOFIN (EU Council of Ministers of Economic Affairs and Finance) Committee

# Key people and groups

- European Securities and Markets Authority (ESMA) – Independent pan-European supervisory body (in charge of level 2 technical drafts)
- Presidency of Council – currently Cyprus – next up Ireland
- Rapporteur – in-charge of guiding regulation through amendments, voting and trialogue process
  - Markus Ferber – German MEP – rapporteur for MiFID II and MiFIR
  - Arlene McCarthy – British MEP – rapporteur for Market Abuse Directive (MAD) and Regulation (MAR)
  - Kay Swinburne – British MEP – rapporteur for CSD legislation but has a lot of influence on other texts

# Level 1 and 2 texts for regulation

- Entirely new process at European level due to move from **D**irectives to **R**egulations
- Level 1 text is baseline for regulation hence will be the regulatory text adopted by each member state – focus of triaologue process
- Level 2 text is produced by ESMA as technical guidelines for implementation and adoption of regulation

# Regulation timeline

- **October 2011:** EU Commission adopts proposals for MiFID II and MiFIR
- **July 2012:** ECON vote on amendments to proposals – delayed until September
- **26<sup>th</sup> September 2012:** ECON vote
- **October/November 2012:** Plenary sitting of EU parliament
- **Q1 2013:** Trialogue negotiations
- **Q4 2013:** ESMA releases definitions and thresholds
- **2014:** Implementation of MiFID II and MiFIR



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# What is MiFID?

- Implemented in November 2007
- Main aim to introduce competition to EU trading landscape
  - Creation of alternative trading venues (multilateral trading facilities MTFs)
  - Harmonisation of pre- and post-trade transparency
  - Passport for investment firms to facilitate cross-border business

# Unintended consequences of MiFID I

- Increased fragmentation but lack of a consolidated tape decreased transparency for buy-side traders
- Relaxed reporting requirements resulting in double and even triple reporting trades
- Multiple trading venues set up their own clearing houses and a lack of interoperability created a complex clearing environment that increased trader's costs

# EU Commission proposals

- Assault on automated trading
  - Article 17.3: Strategy should be in continuous operation during trading hours – posting firm quotes at competitive prices – regardless of prevailing market conditions
- EU Commission fails to distinguish between different types of algorithmic trading and also seems oblivious to execution only algorithmic trading strategies

# MEP amendments: order-to-trade ratio

- Amendments to MAD cite large order-to-trade ratios as abusive order entry
  - Article 10a explains that execution venues must implement rules to prevent abusive order entry and must introduce an additional fee for market participants who exceed a specific order-to-trade ratio
  - Maximum thresholds proposed include:
    - 250:1
    - 10:1
    - 50:1

# MEP amendments: minimum resting period

- Amendments to MiFID II include the addition of a minimum resting period for all orders submitted to an execution venue
  - Amendments state that all orders entered into a system should be valid for a minimum of 500 milliseconds without cancellation or amendment
  - Minimum periods of up to 5 seconds have been suggested by some MEPs

# MEP amendments: banning of DMA

- Markus Ferber's amendments have also suggested the banning of direct market access (DMA) unless the trading party is a member of the exchange
  - “investment firms shall not provide direct electronic access to a trading venue”
  - Only member firms will be permitted to DMA to an execution venue

# MEP amendments: market-making obligations

- Amendments to MiFID II suggest the creation of market-making obligations for specific types of high frequency trading firms
  - Criteria: firms who execute more than 50% of their orders or transactions on trading venues offering discounts or rebates
  - Obligation: must have their algorithms in continuous operation during trading hours, posting firm quotes at competitive prices regardless of prevailing market conditions



# MEP amendments: removal of BCNs

- MEPs are considering removing equities from the organised trading facility (OTF) regime. They believe it will increase fragmentation which will not benefit the market
- Essentially this means broker crossing networks (BCNs) would fall under the MTF regulation or cease to exist
- Widely contested topic between MEPs

# MEP amendments: removal of dark pools

- Amendments to MiFID II suggest the removal of pre-trade transparency waivers, specifically reference price waiver and negotiated deal waiver, which are currently utilised by the majority of dark pools including broker- and MTF-operated venues
- The only waiver expected to be included is large-in-scale (LIS)
- These changes would remove dark pools for the European landscape and shift significantly more trading flow on to the lit markets

# MEP amendments: consolidated tape

- 5 year struggle to establish a consolidated tape
- 1<sup>st</sup> hurdle: No standardisation of condition codes (trade flags) or data format
- 2<sup>nd</sup> hurdle: Exchanges providing only bundled market data (pre- and post-trade)
- 3 options were suggested:
  - A: Single tape, non-profit entity (US model)
  - B: Single tape, commercial entity following public tender
  - C: Multiple tapes, define conditions for entities to follow
- EU Commission proposed option C
- EU Council seems to be favouring option B

# Financial transaction tax

- Aim of this tax is to recoup costs of the financial crisis from the financial sector and align the tax regime on the financial sector with that of other industry sectors
- France has approved an FFT which went into effect on 1<sup>st</sup> August 2012 (Spain expected to follow soon)
- Other countries including Germany, Italy and Austria are also keen
- Tax is expected to be levied at settlement

# US regulation – similar to EU

- Large-trader reporting requirements
- Charging firms per message (or for cancelled orders)
- Banning of “naked” sponsored access (orders must now go through a member)
- Transaction tax
- Adding speed bumps or requiring minimum quote duration
- Fairness of colocation and whether trading obligations should be placed on those firms collocating

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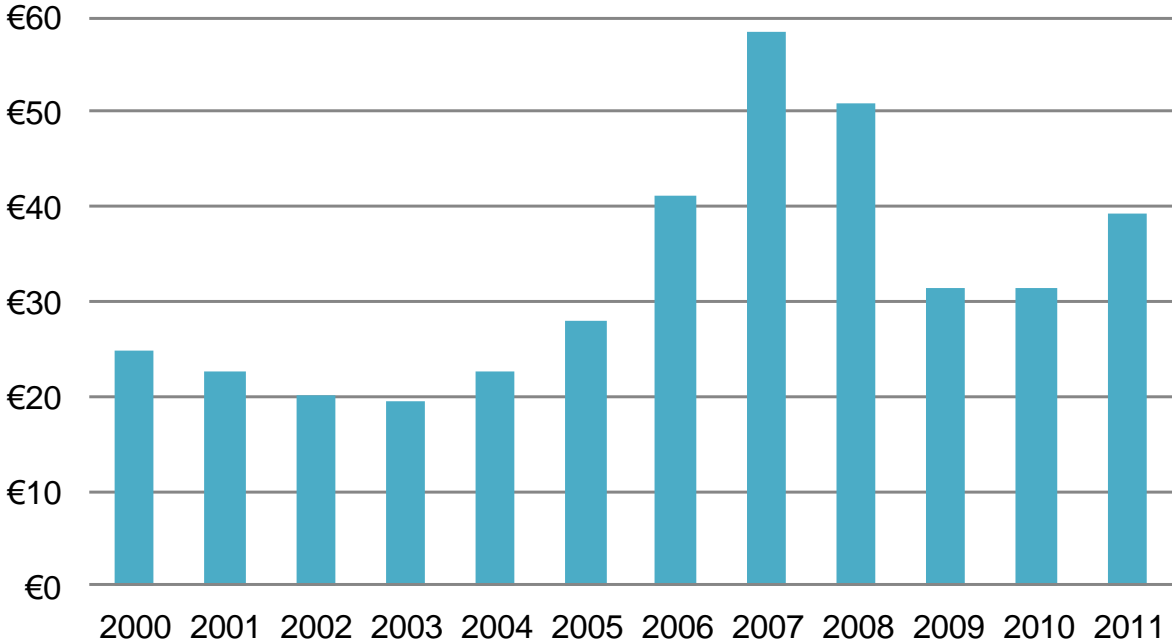
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# Impact on the buyside

- Multiple tapes: buyside fear data will merely be fragmented across multiple tapes
- FTT: charges at settlement will more likely impact buyside than HFT firms that end the day flat
- Removal of dark pools & BCNs: these venues are a source of liquidity and price improvement removing them will increase trading costs for buyside
- Banning of DMA: the majority of HFTs are members of venues but buyside are not. This will have a significant negative impact on buyside traders

# EU liquidity already dwindling

European Equity Average Daily Turnover, 2000 to 2011  
(In EUR billions)

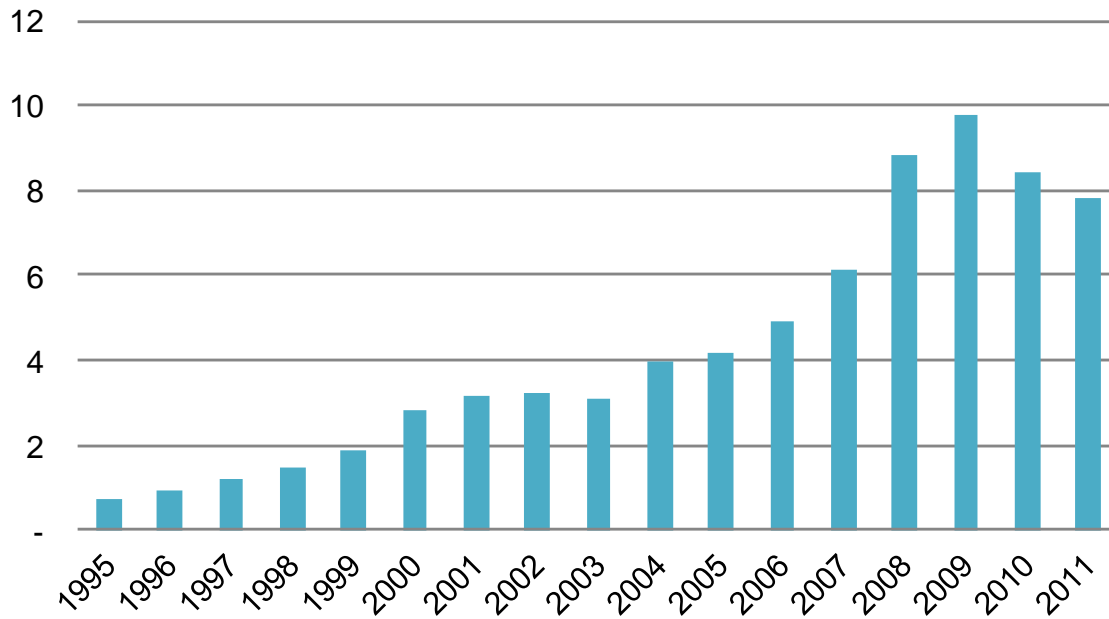


Source: Federation of European Securities Exchanges, World Federation of Exchanges, Aite Group



# US isn't doing much better

U.S. Equities Market ADV, 1995 to 2011  
(In billions of shares)



Source: NYSE Euronext, NASDAQ, BATS Exchange, Direct Edge, SIFMA, Aite Group

# Trades beginning to look elsewhere

- Looking for:
  - Stable liquidity
  - Trading-friendly regulation
  - Developing landscape and competition between execution venues
  - Greenfield opportunities

# Markets that are of interest

- Latin America: Brazil, Mexico and Chile
- Asia- Pacific:
  - Developed markets: Japan, Australia, Hong Kong and Singapore
  - Emerging markets: Korea, Taiwan and India

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