

Competing trading venues: healthy competition or inefficient fragmentation?

Les acteurs anglo-saxons sont favorables à l'intensification de la concurrence sur les marchés financiers européens. En revanche, ils doutent que la nouvelle DSI constitue un catalyseur pour une meilleure intégration des marchés européens. Surtout, ils critiquent les dispositions dont la Commission européenne a assorti les ouvertures à une nouvelle concurrence, tant en ce qui concerne la réglementation des ATS que les règles d'internalisation.



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■ It is ironic that European legislators are attempting to rewrite European securities legislation, the Investment Services Directive (ISD), precisely when the European equity markets are suffering their worst performance for a generation. That said, the objectives of the European Commission reformers are both profound and far-reaching and, if successful, could well bring significant benefits. The intention is to improve the long-term performance of European capital markets by increasing the degree of integration, reducing the cost of capital, narrowing spreads and increasing liquidity. The resulting economic benefits are predicted to be worth approximately 1 % of the European Union's GNP.

On the face of it, the European capital markets seem relatively efficient already. Corporates appear to list with ease, usually on their national markets. Secondary market trading also appears satisfactory. The main execution venues in Europe are the national stock exchanges, which have adopted efficient electronic trading systems based on the central limit order book (CLOB) model. Under a CLOB, users submit anonymous bids and offers, usually at set or « limit » prices, to a central order book accessible to all other users, who can then « hit » on bids and offers they want to accept. Brokers execute most of their client orders on these exchanges, and are able to use the existing Investment Services Directive to access exchanges

across the EU. And investors, both institutional and retail, in turn have access via their brokers, often electronically, to a range of markets.

ISD objectives

So what then are the problems and the inefficiencies in European markets? And what can the new ISD do to resolve them? I will focus on equity markets, where to my mind the Commission faces two main issues.

Firstly, the equity markets in Europe are national. In short: they lack scale. More integrated – for which read bigger – European markets would be deeper, more liquid and more competitive with their US rivals. The ISD therefore proposes common standards for brokers and exchanges in order to facilitate the ability of brokers and exchanges to offer their services across the EU, which in turn should facilitate integration. Other legislation on common listing and disclosure requirements is similarly intended to allow for pan-European markets.

Secondly, the Commission wants to use the ISD amendment to encourage fair competition between different forms of intermediaries. In particular, the Commission proposes the removal of the right for member states to prescribe a monopoly for execution on exchanges, the traditional official or public markets, under the so-called concentration rule. This right has been enshrined in the original 1993 ISD. For their part, most ex-

changes, which currently dominate trading in Europe, feared that the removal of this provision would mean them losing ground either to new competitors such as electronic agency brokers (like Instinet!) or to more conventional market makers executing client orders off-exchange. They therefore argued for a level regulatory playing field for all such execution venues and ideally for all exchange-like entities to be regulated as exchanges. Without this, warned the exchanges and some regulators, trading would become fragmented across different, competing venues with adverse implications both for investors (best execution would be harder to achieve) and for markets (liquidity and price transparency would be fragmented and dispersed). The Commission therefore proposed applying similar levels of regulation to both exchanges and multilateral exchange-like platforms and in addition to increase the regulation of off-exchange trading executed « internally » by market makers. The Commission's focus was to apply transparency both to bids and offers (« pre-trade ») and of executed trades (« post-trade ») in all cases, irrespective of the execution venue.

Delivering scale

But the reality underlying the assumptions behind these twin objectives is more complex than at first sight. And the Commission's ambition is grander than perhaps many realise. Take the first

issue of scale. The fact is that European authorities cannot legislate for scale. It is the market itself that will have to deliver consolidation. Consider what this means. At the exchange level, because the main exchanges have demutualised over the last decade, mergers and take-overs are possible. Euronext is an excellent example of organic consolidation via merger. The failed take-overs of London by first Frankfurt and second Stockholm show another possible route. But a third and perhaps more intriguing possibility is for a « national » exchange to offer trading in another's stocks and for Europe to see a number of competing pan-European exchanges. Such competition does occur now (London trades some international stocks, so does Deutsche Boerse, and Virt-x is an openly pan-EU market twinned with the domestic Swiss market) but on a small scale. The reason for the lack of competition to date is obvious: liquidity is paradoxically illiquid, and tends to settle in the dominant national market. But liquidity can and does move. The shift in liquidity in futures trading from LIFFE to Eurex a few years ago is a striking example.

Scale is perhaps even more important at the back office level and in delivering straight through processing (STP). In terms of clearing, we in Europe are in the middle of a fascinating market driven process to deliver both a cross-market central counterparty (CCP) functionality and a cross-market settlement function. The former may prove to be modelled on the London Clearing House and Clearnet, with the aim of ultimately providing netting across a number of different cash, derivative and OTC markets; the second on Euroclear, supplying the Euronext equity markets, CREST in the UK and the international bond markets. In both cases the aim is to deliver user-governed utility-type structures to support cross-border trading activity. Meanwhile Deutsche Boerse Group has decided to offer its users a vertically integrated service comprising trading, clearing and settlement.

At the broker level, cross-border activity is indeed possible using the so-called ISD passport, but markets remain again somewhat national and fragmented. Not one broker has a significant cross-border market share. This is partly due to regulatory barriers, since most

member states do not fully recognise the authority of the broker's home state's regulator and apply duplicative regulation at the local or host state level. Indeed, removal of this duplicative regulation, at least for dealing cross-border with professional clients, was the main expectation of ISD from brokers. But again achieving scale is primarily a question of maturity and commercial reality. Consolidation will come – helped probably by technology – but will take time and will probably come at the same time as consolidation in the banking, insurance and asset management industries.

In summary, the ISD itself will not deliver the increases in scale presupposed by the Commissions bold economic expectations (issued, no doubt, to put political pressure on member states to agree its proposals). What seems to me to be true, however, is that by reinforcing the rights of all players in the market to compete on a fair and level playing field, the ISD should help market participants deliver benefits to their issuers, investors and ultimately to the real economy. Only time will tell, but a pro-competition ISD should at least send market participants a positive signal. The true test of the ISD that will emerge from the political discussions just beginning in Brussels will indeed be whether it does actually increase competition, or whether it falls victim to protectionism and vested interests.

Levelling the playing field

The second ISD objective has proved controversial. In one sense, this was perhaps to be expected, since increasing competition is always likely to affect varying vested, commercial interests and to be seen as a threat to market incumbents. But in another sense, it has revealed a philosophical divide as to how to ensure market integrity in cross-border equity markets, a divide that could yet prove too deep to master. To explain this, it is worth going back to basics for a moment on the regulatory and economic roles of the various players in equity execution.

- Start with exchanges. The price formation process in equity markets is heavily regulated at national level and the exchanges bear a significant part of this regulation by having specific responsibility for the integrity of trading on their systems. Exchanges are generally requi-

red to have rule books that ensure fair and orderly markets. This is not to forget the important listing and disclosure obligations – not least in the current climate — on the issuers of securities.

From an economic perspective, exchanges make money from execution fees. As a result, they have a direct incentive to hold on to liquidity to bring in more business, to charge per execution and — taking a cynical view — to seek regulation that prevents or restricts execution off-exchange. Exchanges can also make healthy

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profits from data – both from selling their pricing data (and everyone needs it if they are the dominant market place) and from charging members fees for reporting off-exchange trading to them.

- Brokers are subject to a range of investor protection and market manipulation rules, most notably requirements to achieve best execution for their clients and are regulated accordingly. Brokers can execute their client orders elsewhere than their local exchange — on a competing exchange, bilaterally with other brokers, directly on their own account with the client (traditional inventory management or « market making ») or by matching them with other clients orders (often called « internalisation »). Brokers have an economic incentive not to execute on-exchange in order to reduce execution fees, but they need liquid venues such as exchanges in order to execute client trades. In practice they will tend to take the exchange as a benchmark price, and reserve the right to execute off-exchange at that price or better. Therefore there is a constant economic tension between exchanges and their broker members, since they both compete with and complement each other. This is not a new phenomenon of course, but one made more interesting once exchanges demutualise and are accountable to shareholders rather than users. A further re-

cent development in the US has been the emergence of agency broking platforms that have attracted significant liquidity in the « over the counter » (OTC) market.

- Institutional investors have a range of options: they may simply ask a broker to execute trades for them, they may similarly internalise trades before they are sent to brokers, or they may send them directly to an exchange, either via a routing broker or by being members themselves. Institutional investors face a trade-off between liquidity and transparency – they need liquidity to execute large trades but fear incurring market impact costs when exposing large trades to exchange's limit order books. In order to minimise transaction costs, they will often seek execution elsewhere. One option is to use a crossing system or an agency trading platform, to preserve anonymity and minimise market impact. Alternatively, their broker may work their trade for them, typically by splitting up large orders and trying to achieve some kind of benchmark price such as the day's VWAP (volume weighted average price) or by committing capital to the trade, giving the client immediacy and working off the risk themselves. But multiple sliced orders are hit by transaction fees – which would account for the buoyancy of exchange revenues in recent months.

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One interesting question currently under debate in the UK is whether institutional investors pay enough attention to transaction costs. Arguably, they have little economic incentive to do so since these costs are charged back to their clients. The UK Government has followed the recommendations of Paul Myners' report which calls for pension funds to demonstrate that they are monitoring and controlling the costs incurred by their asset managers. Hopefully, we should witness some change in market behaviour in the UK.

- Finally, the average retail investor usually operates entirely in the hands of

their broker. In theory, a proper process of best execution should mean that these brokers check a number of prices but current best practice is typically just to ensure the trade matches or better the exchange price.

Given these factors, it is not surprising that the reality of where trades are executed in Europe make for a constantly changing landscape and one where hard facts are difficult to come by. Substantial trading takes place off the exchanges in Europe, or at least away from their public electronic order books, since some exchanges have « off order book » markets. The task of regulators in all of this is to ensure that market integrity and investor protection is ensured, whatever the market structure.

So how does the ISD propose to achieve a level regulatory playing field a framework to overlay this complex interaction of different interests?

Common standards for exchanges

As far as exchanges are concerned, the ISD proposes a set of common standards. Based on the Committee of European Securities Regulators' standards (CESR), they are regarded as codification of best practice from across the member states. They cover authorisation requirements, fit and proper management, listing rules, rules on fair and orderly trading, market surveillance, pre- and post-trade transparency. The only oddity in these rules is that they restrict exchange membership to a category of users called « eligible counterparties ». These rules exclude some potential users who are not regulated banks or investment firms, and are taken by some to exclude non-European users. As will be obvious from the analysis of the economics above, most exchanges are eager to attract end users to their markets and have a clear commercial incentive to disintermediate their broker members. The proposal therefore appears *prima facie* to be anti-competitive.

Equating MTFs with exchanges

Some European regulators and exchanges fear that off-order book transactions are a threat to market. They argue that technology has facilitated order

matching by brokers and asset managers, this risks fragmenting markets, which in turn will damage market integrity and liquidity. A particular concern has been that electronic agency platforms could attract significant market share in Europe and divert flow away from the exchanges. These firms, known as Electronic Communication Networks (ECNs) in the US have attracted significant market share in the OTC equity market (or NASDAQ). The merged Instinet and Island, for example, are the largest ECN with approximately 30 % of the OTC equity market.

Under pressure from the exchanges, the regulators acted in advance of the ISD and last July agreed common standards outlining additional regulation for brokers operating Alternative Trading Systems (ATS), defined as multilateral order matching systems. The rationale behind the paper is not entirely clear. Equity ATS activity is minimal in Europe, where exchanges dominate and where OTC activity is concentrated in the larger banks, investment firms and asset managers. Furthermore, equity ATS activity – according to CESR members – is concentrated in London, where it is already regulated and monitored alongside the exchanges by the FSA. And in other markets such as the bond markets, fixed income ATSs have increased transparency and liquidity by common consensus in what was an OTC market. The Commission certainly has never appeared entirely convinced by the CESR ATS paper, but has accepted its consensus and broadly copied its standards into the ISD proposal as requirements for MTFs. The net effect is that rules on MTFs essentially mirror rules on exchanges, the only exception being that MTFs are brokers.

Equating MTFs with exchanges raises a number of competition concerns. For a start, setting exchange regulation as a benchmark for those brokers with whom they compete strikes a suspect note, given the dominant position of many exchanges. In other sectors such as telecommunications, regulation has been used deliberately to encourage competition against incumbents operating from a position of scale. Indeed, the whole question of exchanges regulating their members is an interesting one now that they are openly in commercial competition with them.

Another peculiarity is the definition of a MTF. CESR seems to have tried to distinguish « multilateral » or agency type business from other « bilateral » forms of trading, such as market making where brokers act as principal, and to impose a « non-discretionary » test to catch automated electronic systems that appear similar to the electronic order books of exchanges. But the definition still begs a number of questions. Are the automatic agency trading platforms of the market makers and voice brokers caught? Economically, they are certainly larger than their MTF competitors and account for more off-exchange matched trades. The problem is that CESR really wanted to catch off-exchange price formation, but that is a rather abstract concept. Certainly the equity MTFs that are likely to be caught appear to have a minimal affect on the price discovery process, either because they are price taking (such as crossing systems) or used primarily to route orders to exchanges (like Instinet). Unlike the US OTC market where MTFs do play an important role in price discovery, Europe has its exchanges. MTF regulation is therefore at best precautionary, and at worst anti-competitive.

Internalisation: abandoning the concentration rule

The more recent debate over the threat of off-exchange trading to market integrity and investor protection has moved away from MTFs, which collectively account for a very small share of equity trading, to the role of internalisation by market makers (though not, curiously by asset managers). Here, views are split. The « concentrators » argue that price formation must be centralised and that if prices are formed elsewhere, on MTFs or within market makers, then markets will suffer and investors will not be assured of access to the best prices. The « fragmenters » on the other hand argue that competition is essential and that technology enables the collation of prices a variety of venues to be dispersed to all users.

The Commission is clear that the concentration rule should be abandoned citing evidence to compare markets both with and without the rule illustrating no damaging effect on efficiency. It does accept that brokers in return must do more

to ensure market integrity and investor protection. But precisely what form should these additional obligations take? At the extremes, the concentrators have argued that brokers should have to replicate the exchange and MTF rules (fair and orderly trading, publication of quotes and executed order details), whereas fragmenters have argued for no change, relying on their existing obligations to achieve best execution for their clients.

In the proposal floated last autumn, the Commission decided to rely on transparency as the main defender of market integrity and suggested brokers should have to publish details of all executed trades. This poses a significant cost to those member states (eg Germany) where off-exchange trading is not currently published. At the last minute, the Commission put forward a provision requiring market makers to publicly display their off-exchange quotes in some circumstances. Market makers have reacted angrily to this requirement, insisting that this will limit their ability to offer price improvement to their clients. The concentrators have responded that significant off-exchange trading can influence price formation and that prices should be published so that the whole market can see whether the exchange price is the true market price. The Commission also suggested a range of investor protection provisions, on managing conflicts of interest, obtaining the best possible result for the client and reviewing these best execution procedures. In addition – and again controversially – it proposed gaining the specific consent of the client for execution to be off-exchange. Brokers have responded that this amounts to a virtual concentration rule.

Next steps

It is too early to say how the European legislators will react to the detail of the proposed ISD amendments. The European Parliament's initial reaction from its British rapporteur has been critical of some of the elements of additional regulation of brokers as anti-competitive, and earlier Parliament reports from other MEPs had also called for more competition, but the Parliament is unlikely to totally reject a compromise agreed on by all the EU's regulators and governments. Much will therefore depend on a number of key member states. France has led the

« concentrators » in arguing that greater competition must be accompanied by detailed common rules setting almost identical rules for exchanges, MTFs and internalisers. Spain – which has still failed to implement the original ISD requiring the granting of remote access rights to stock exchanges – opposed even accepting the possibility of MTFs in the CESR paper and can be expected to oppose liberalisation. Italy, the next EU Presi-

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dency, is similarly a concentrator. The UK, having led the CESR exercise on MTFs, is broadly content with the Commission proposal but is thought to regard the pre-trade display requirement for brokers as unworkable. Germany is likely to be the most resistant to the additional regulatory requirements, since its current domestic regulation permits extensive off-exchange trading.

A best guess might see the proposal agreed with relatively few substantive changes to the high level requirements in the legislation, but with many of the arguments deferred to the discussion of the details of how to implement them. Those discussions will take place in the new Lamfalussy Committee structure, with the Securities Committee and CESR facing a heavy workload. Even on a fast timetable, the legislation is unlikely to be finalised for another year with the secondary regulations taking another year to agree. On past history who knows how long it will take before they are fully implemented across the whole EU.

The irony is that by then we might have a very different European landscape in the securities markets. A concentration of cross-border exchanges? A single Central Counterparty? A single settlement utility? A handful of liquidity pools operated by brokers or MTFs? Who knows? But the ultimate test of success will be whether costs will have fallen and this will not be achieved without greater competition. ●