
IR Implications of the New MiFID Trading Environment

De-mystifying “dark pools”, “algorithmic trading” and “direct market access”

18 May 2009



MAKINSON COWELL

Agenda

Pressures for change

Evolution

Current position

Next?

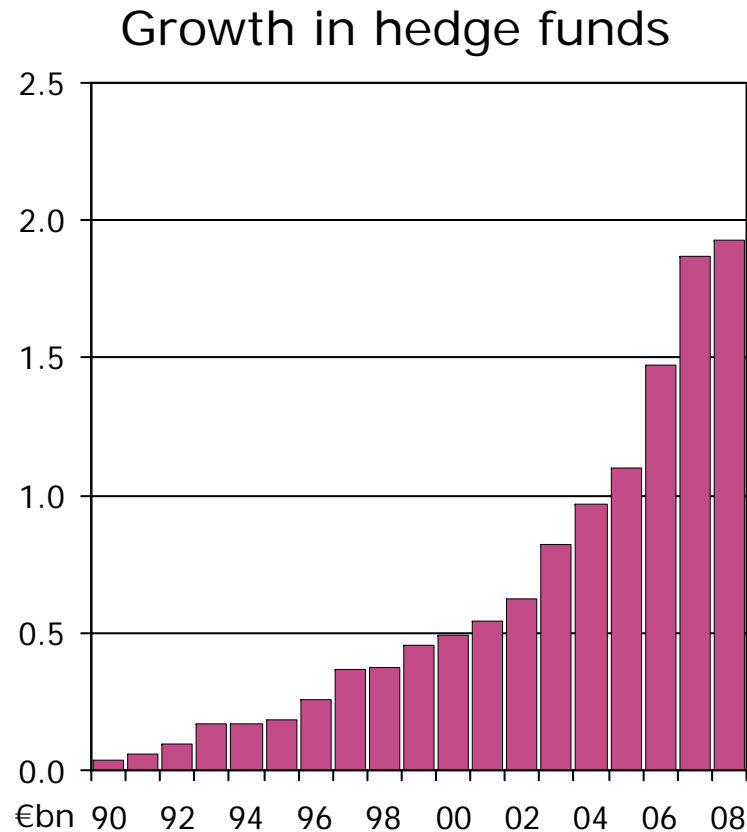
Pressures for change – Market performance

World markets index performance



- Post internet boom indices fell
 - US 44%
 - Europe 52%
- Fund management income fell
- Focus on efficiency

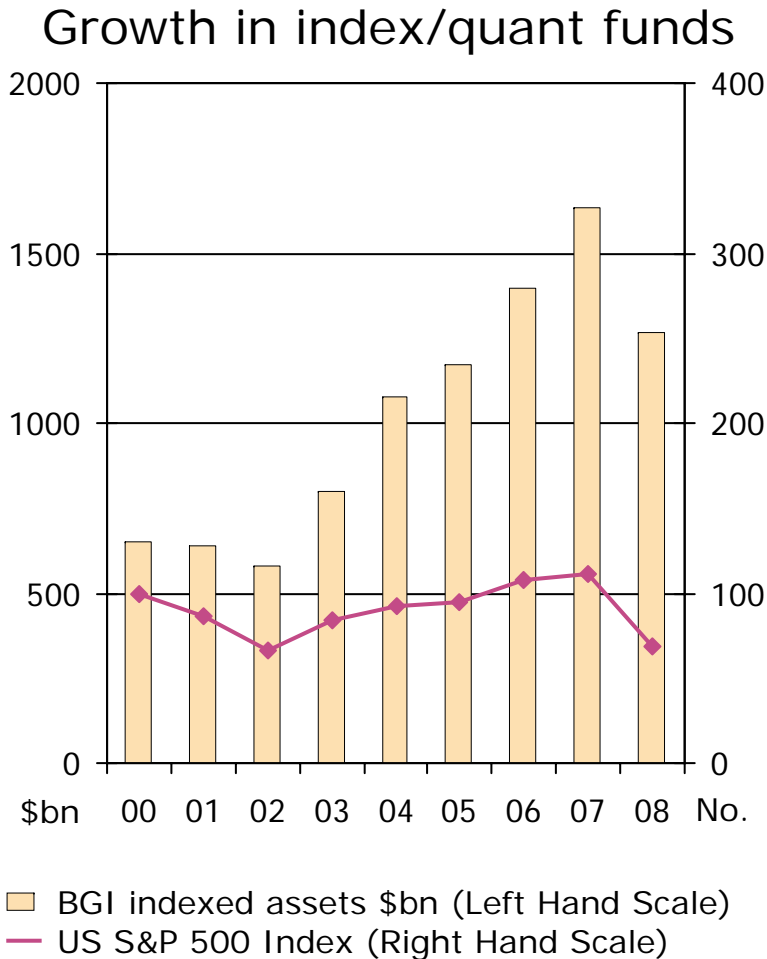
Pressures for change – Hedge funds



Sources: *HedgeFundManager Week*,
Morgan Stanley

- Global hedge fund assets grew 20% p.a. over the 7 years from 2000
- Attraction of alpha
- High return, high risk
- Competition to traditional fund managers

Pressures for change – Index funds



Source: Barclays Global Investors

- Index funds grew 14% p.a. over the 7 years from 2000
- Based on BGI
- Low risk, low fees
- Competition to traditional fund managers

Pressures for change - Unbundling

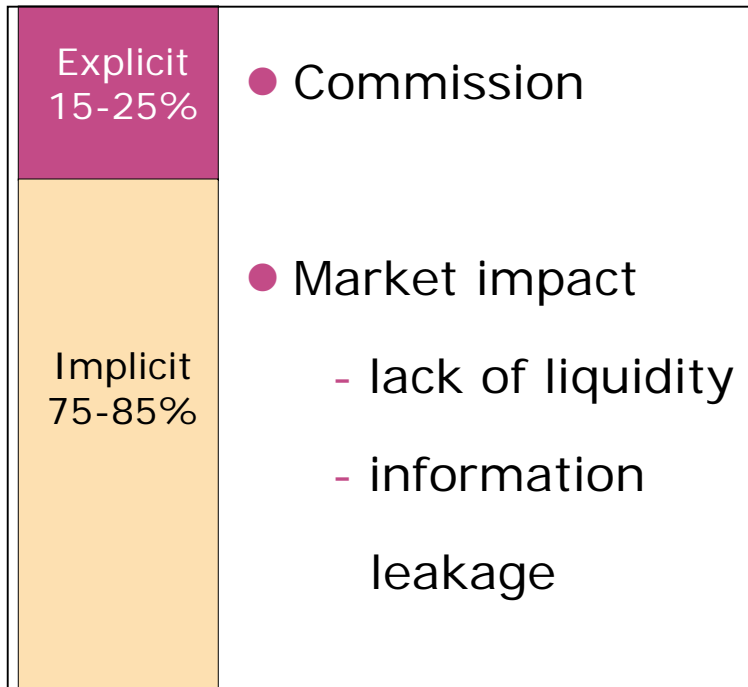
- Commission

- costs of execution
- costs of research
- computer services
- rent, travel
- entertainment etc

- Borne by sell-side
- Recharged to buy-side and on to their clients
- Market pressure and regulation on disclosure
- Focus on costs

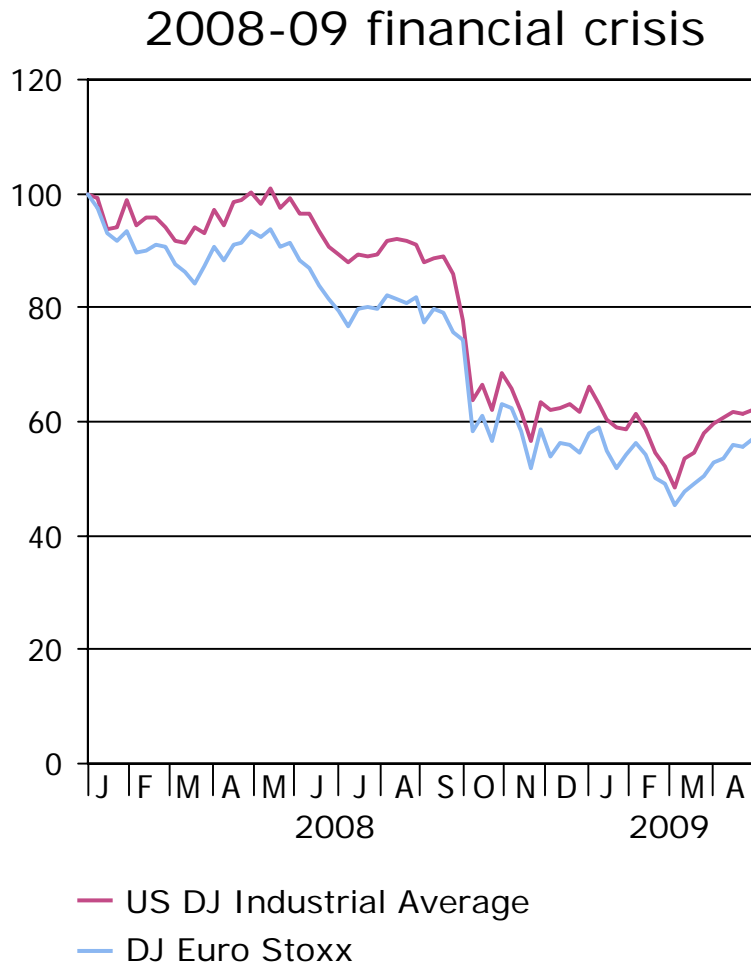
Pressures for change – Transaction costs

Focus on implicit costs



- Research showed costs of market impact on transaction costs
 - size of trade
 - trading parties
 - price limits
- Focus on costs

Pressures for change – Financial crisis



- Continued cost pressure
- High volatility intraday price sensitivity
- High volumes

New technology



Regulation – MiFID and NMS

Markets in Financials Instruments Directive (MiFID)

- Scope is cross-country, cross product
 - internationalisation of trade
- Introduces best execution
 - must consider price, cost, speed, likelihood of execution, likelihood of settlement
 - must have a policy
- Types of firms
 - regulated markets
 - multilateral trading facilities
 - systematic internalisers
- Implemented November 2007

Regulation – MiFID and NMS

National Market System (NMS)

- Adopted by SEC in April 2005
- Automated systems then completed
- Phased in from March 07, mandatory from October 07
- Focused on best execution = price

Both

- Post-trade reporting and analysis systems important
 - sophistication of software varies
 - best execution compliance
 - post trade cost analysis

Agenda

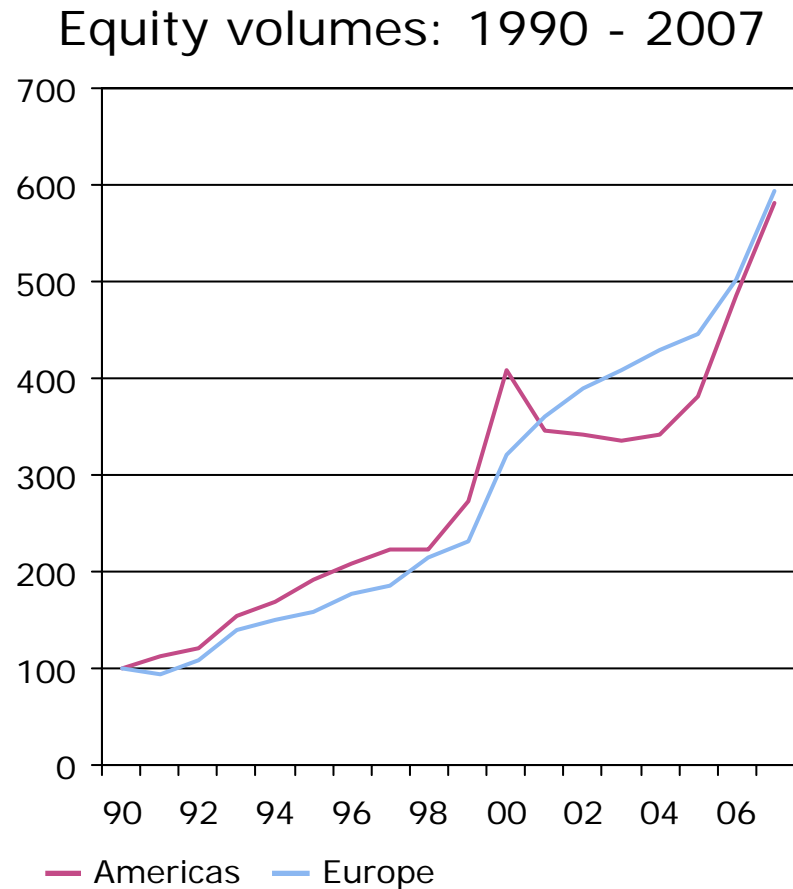
Pressures for change

Evolution

Current position

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Evolution – Volumes up, trade size down



- Strong upward trend
- Volumes increase as costs of trade fall (implicit and explicit costs)
- Faster technology, greater capacity
- Growth resumes after internet boom ends

Sources: World Federation of Exchanges, value of cash equities adjusted by price indices and rebased, Europe includes ME and Africa.

Evolution – Volumes up, trade size down

Equity volumes: Nov 07 – Mar 09



- Pattern is the same in Europe and the Americas
- Average velocity in Europe
 - around 115% in 2005
 - reached 150% in 2008

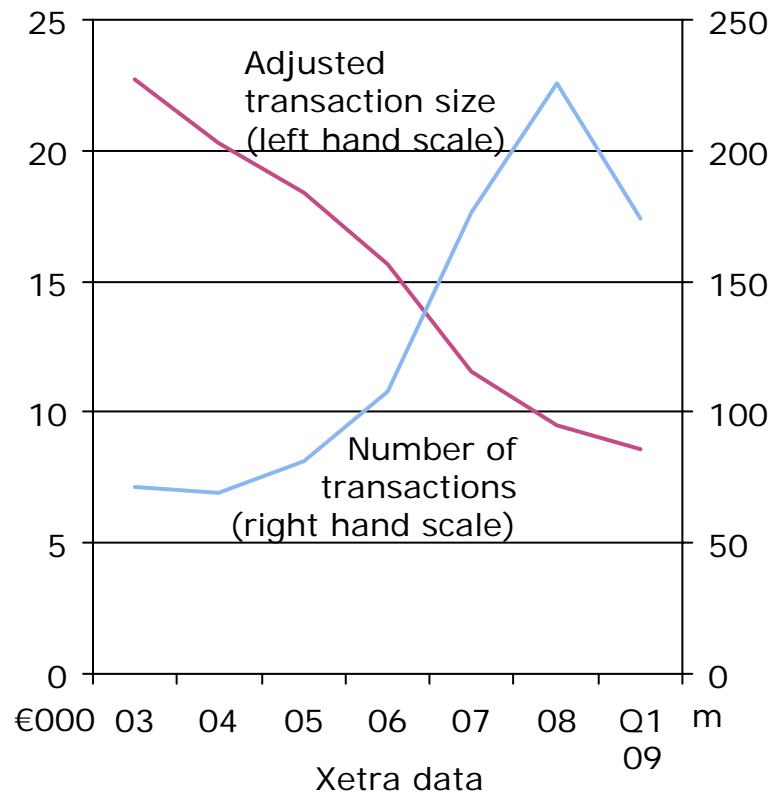
Sources: Americas - World Federation of Exchanges, value of cash equities adjusted by price indices and rebased, Europe includes ME and Africa. Europe - Euro Composite velocity of MSCI Pan-Euro Index rebased.

Evolution – Volumes up, trade size down

- Slicing bargains into smaller pieces reduces market impact
- New technology divides and routes orders to achieve best execution
- Many more markets and prices where part of a trade can be executed
- Block trades need not be outside the spread
- Bargains may be spread through the day to spread risk in extreme volatility

Evolution – Volumes up, trade size down

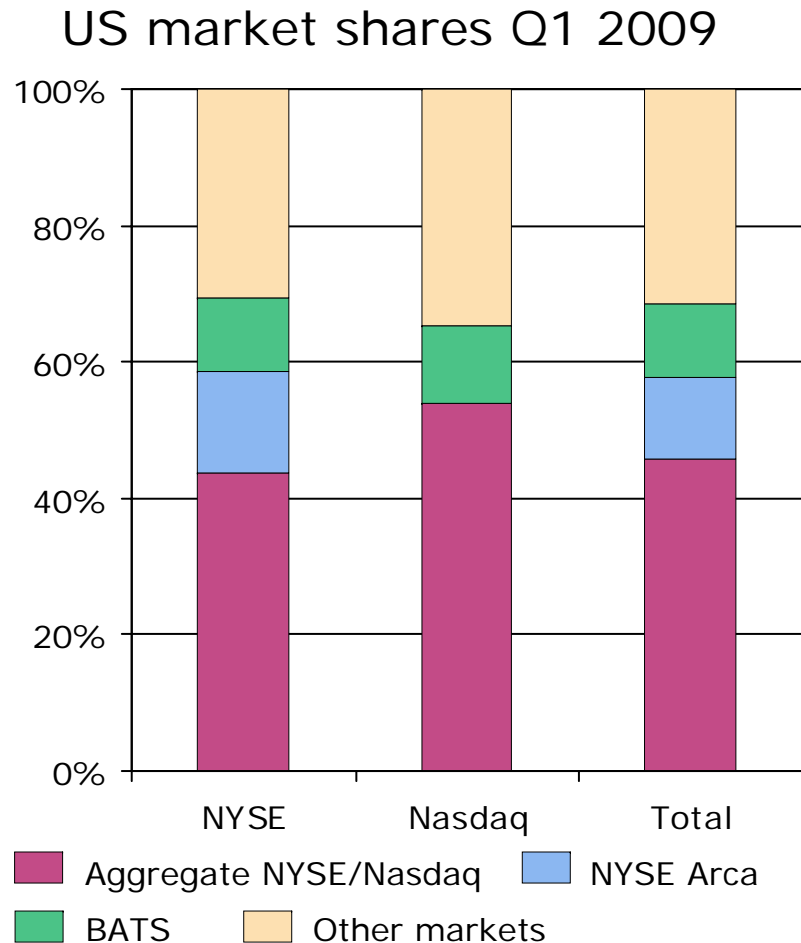
Transaction size compared
to number of trades



- Transactions up 28%
- Value per transaction down 31%
- Transaction size adjusted for price changes down 18%

Source: Deutsche Börse annual reports, values adjusted by movement in DAX and rebased to average transaction size in 2008. Q109 annualised

Evolution – US market shares



Source: Volumes tapes as reported on NYSE, Nasdaq and BATS websites

- By 2007, <50% traded on market where listed
- NYSE acquired Archipelago in 2005 to form NYSE Arca
- BATS commenced trading in August 2006
- Internalisation accounts for >65%, of other non-traditional trade

Evolution – Buy-side and sell-side

Buy-side

- New venues and systems are:
 - faster “low latency”
 - more efficient
 - lower costs
 - increase capacity
 - anonymous
 - provide compliance records
- Direct market access:
 - but 50% remains with broker
 - expertise invaluable
 - trading decisions more complex
 - expensive to connect to ever more venues

Evolution – Buy-side and sell-side

Sell-side

- IT systems have become a business segment
 - attract new business
 - offered to clients
 - provide essential help to all but the biggest buy-side firms
 - but requires investment
- Smaller brokers
 - IT may be too expensive
 - but receive income for research via commission sharing agreements

Agenda

Pressures for change

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Current position - regulated markets

- 8 major groups
- 21 markets

NYSE Euronext

France - SBF
Netherlands - AEX-E
Belgium - BSX
Portugal - BVLP

DB

Germany - DB
- regional
markets

Spain

Bolsas y Mercados Españoles

Austria

Wiener Börse

Nasdaq OMX

Denmark - CSE
Finland - HEX
Sweden - OM Stockholm
Iceland - ICE-X
Baltic - Latvia
- Estonia
- Lithuania

SIX Group

Switzerland - SIX Swiss
Exchange

Norway

Oslo Børs

LSE Group

UK - LSE
Italy - Borsa Italiana

Ireland - Irish SE
Luxembourg - Lux SE
Greece - Athens SE

Current position – European MTFs

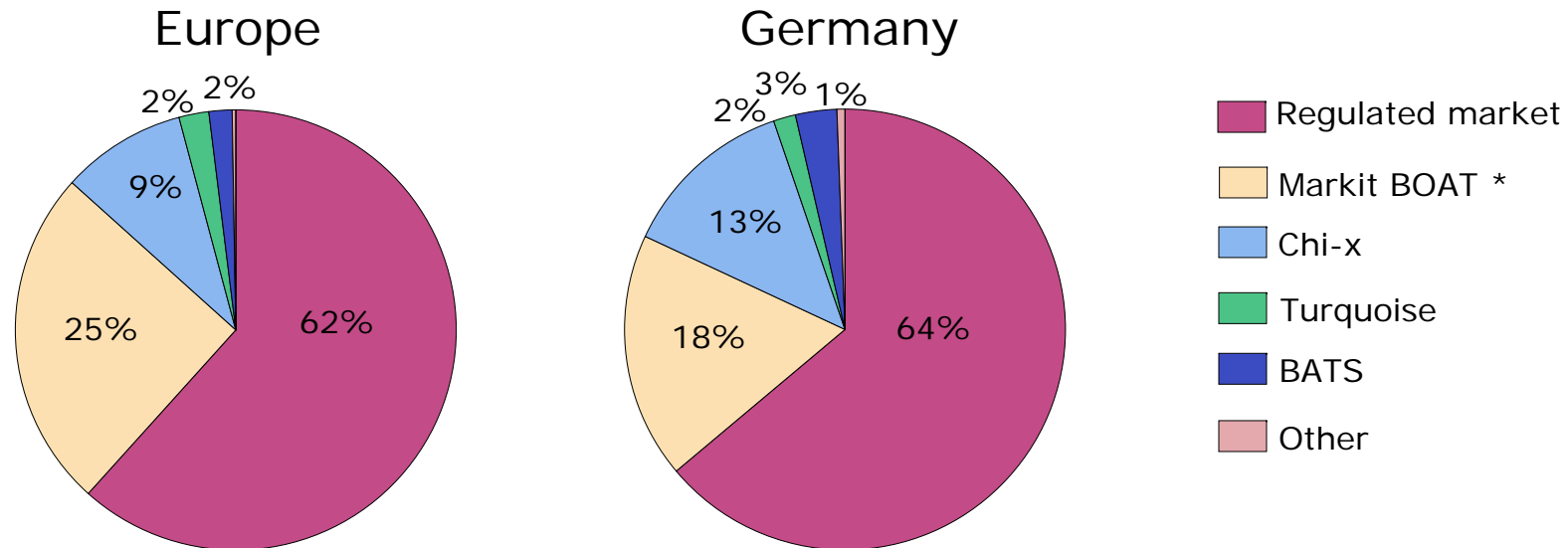
Launch	MTF	Market	Owners/sponsors	Dark/Light
Nov 02	Liquidnet /H20 (Dec 08)	Europe	Private company	Dark
Feb 07	POSIT	Europe	ITG	Dark
Mar 07	Chi-x	Europe	Instinet Europe, Nomura	D/L
MiFID				
Mar 08	Euro Millennium	Europe	NYFIX	Dark
Jun 08	Instinet BlockMatch	Europe	Nomura	Dark
Jun 08	PEX	Portugal	OPEX-SGSNM	Light
Aug 08	SWX Swiss Block	Swiss	SIX Group (widely owned)	Dark
Aug 08	Turquoise	Europe	9 investment banks #	D/L
Sep 08	Nasdaq-OMX Europe	Europe	Nasdaq OMX	Light
Oct 08	BATS Europe	Europe	BATS Holdings	Light
Oct 08	Equiduct Trading	Europe	Börse Berlin	Light
Nov 08	Xetra Midpoint	German	Deutsche Börse	Dark
Feb 09	NYX Smartpool	Europe	NYSE Euronext, HSBC, BNP, JPM	Dark
Feb 09	PLUS Europe	UK	Bayerische Börse	Light
Mar 09	NYSE Arca Europe	Europe	NYSE Euronext	Light

Citigroup, Goldman Sachs, Merrill Lynch, Morgan Stanley, UBS, Credit Suisse, Deutsche Bank, BNP Paribas and Societe Generale

Current position – Dark pools

- Scheduled crossing
 - small part posted on order books
 - much larger amounts settled
- Negotiated crossing
 - alerts sent to potential matching partner
 - anonymous negotiation
- Continuous blind crossing
 - continuous matching
 - may provide signals of interest but not whether buy or sell or price
- Broker internal crossing
 - also called internalisation
 - orders received or directed through internal networks & matched
 - both retail and institutional

Current position – MTF share of trade



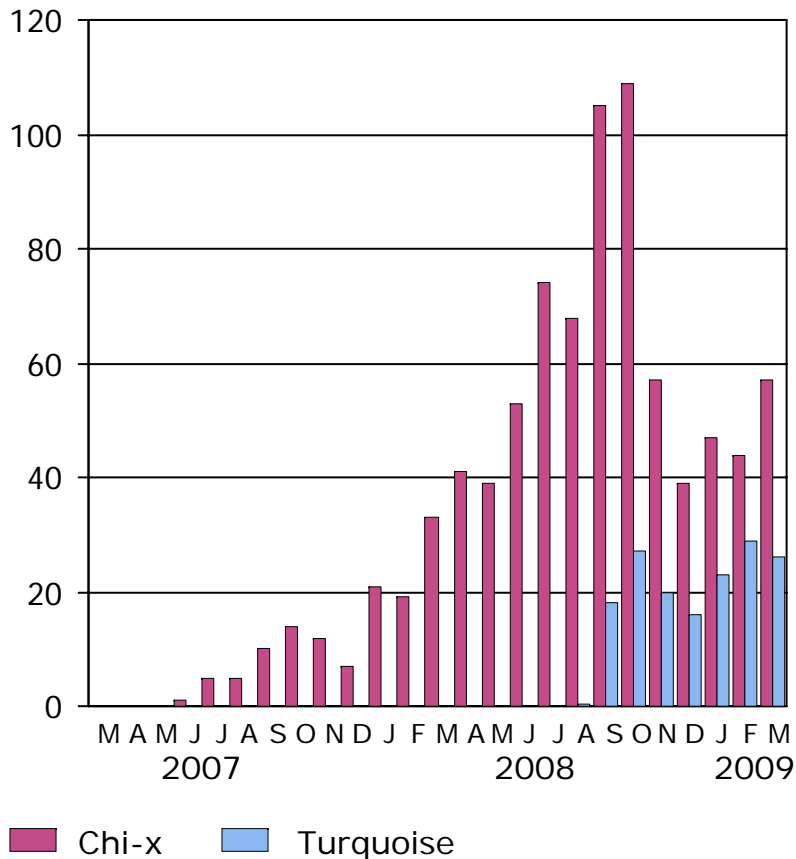
- MTF share in Europe is about 14%
- Highest share in the UK: Chi-x has 14%, Turquoise 5% and BATS 2%

** Markit BOAT reports on behalf of - MTFs: NYFIX Euro Millennium, POSIT, Liquidnet - SIs and others: ABN Amro, Bank of America, Barclays, BNP Paribas, Calyon, CA Cheuvreux, Citadel, Citibank, Credit Suisse, Deutsche Bank, Dresdner, Goldman Sachs, HSBC, JP Morgan, Merrill Lynch, Morgan Stanley, State Street and UBS*

Source: Fidessa Fragmentation Index, Makinson Cowell estimates

Current position – Chi-x and Turquoise

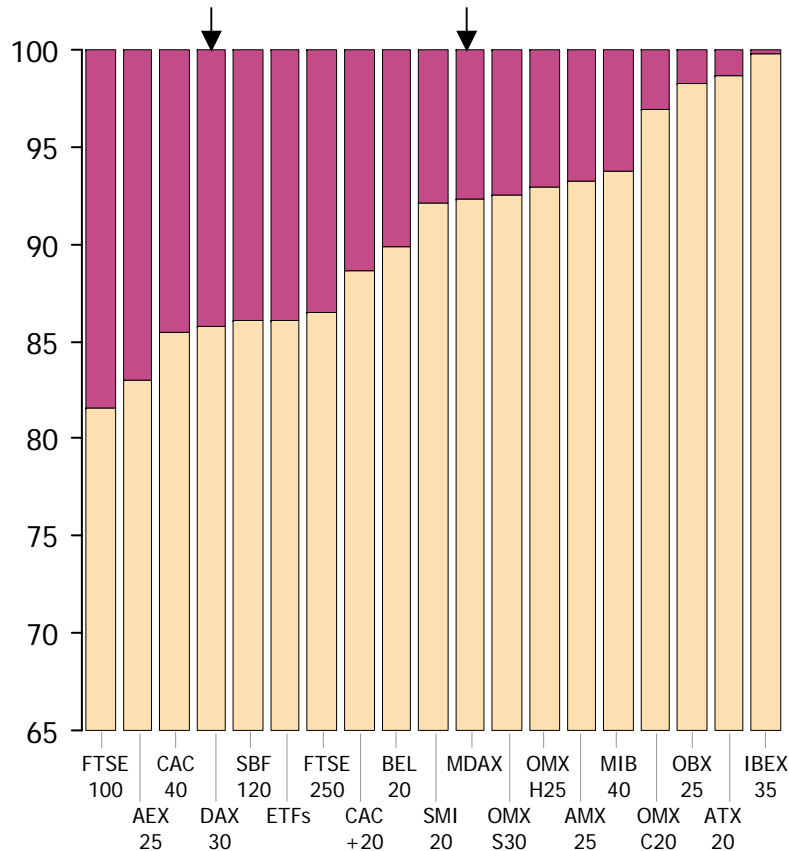
Volume of matched bargains €bn



- Pan-European matching engines
- Chi-x
 - small orders visible
 - large orders dark
 - Chi-Delta small orders dark
- Turquoise
 - small orders visible
 - large orders dark

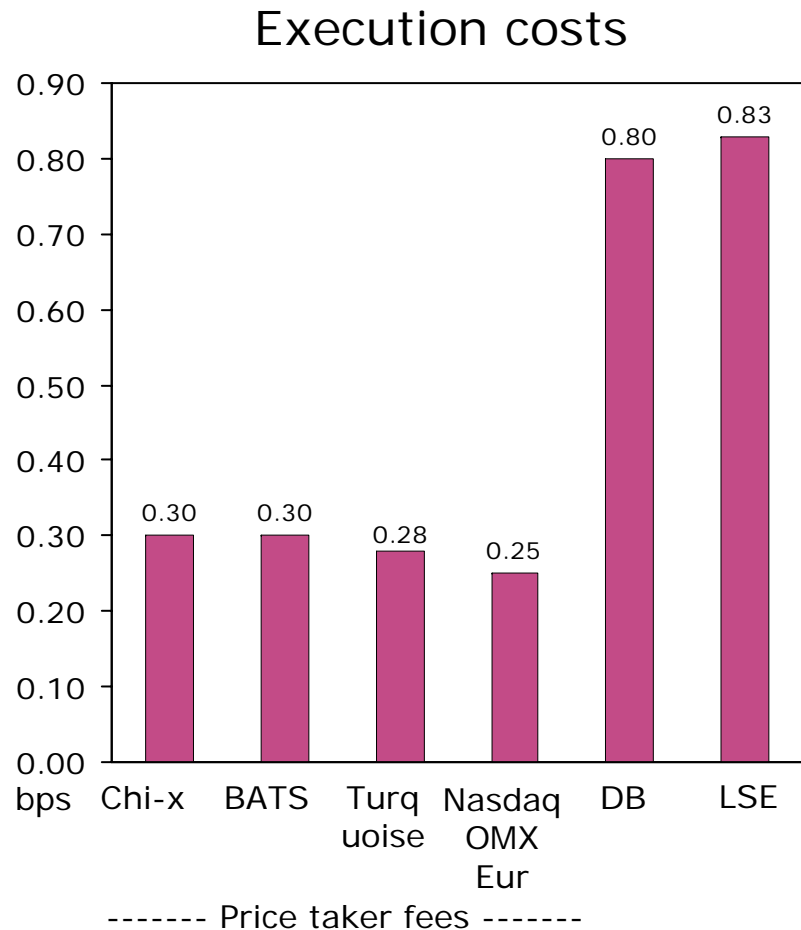
Current position – Chi-x and Turquoise

Chi-x % of on-orderbook activity Q109



- Both cover Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Spain, Sweden, Switzerland and the UK
- In addition Turquoise covers Ireland and Portugal
- Maker/taker price model

Current position – Fees



Source: Morgan Stanley research January 2009

Maker/taker model

- “Aggressive”
 - traders who remove liquidity/those that take up orders
- “Passive”
 - traders who provide liquidity/ those that post orders
- Example: Turquoise
 - aggressive: 0.28 bps
 - passive: -0.20 to -0.24 bps

Current position – Systematic internalisers

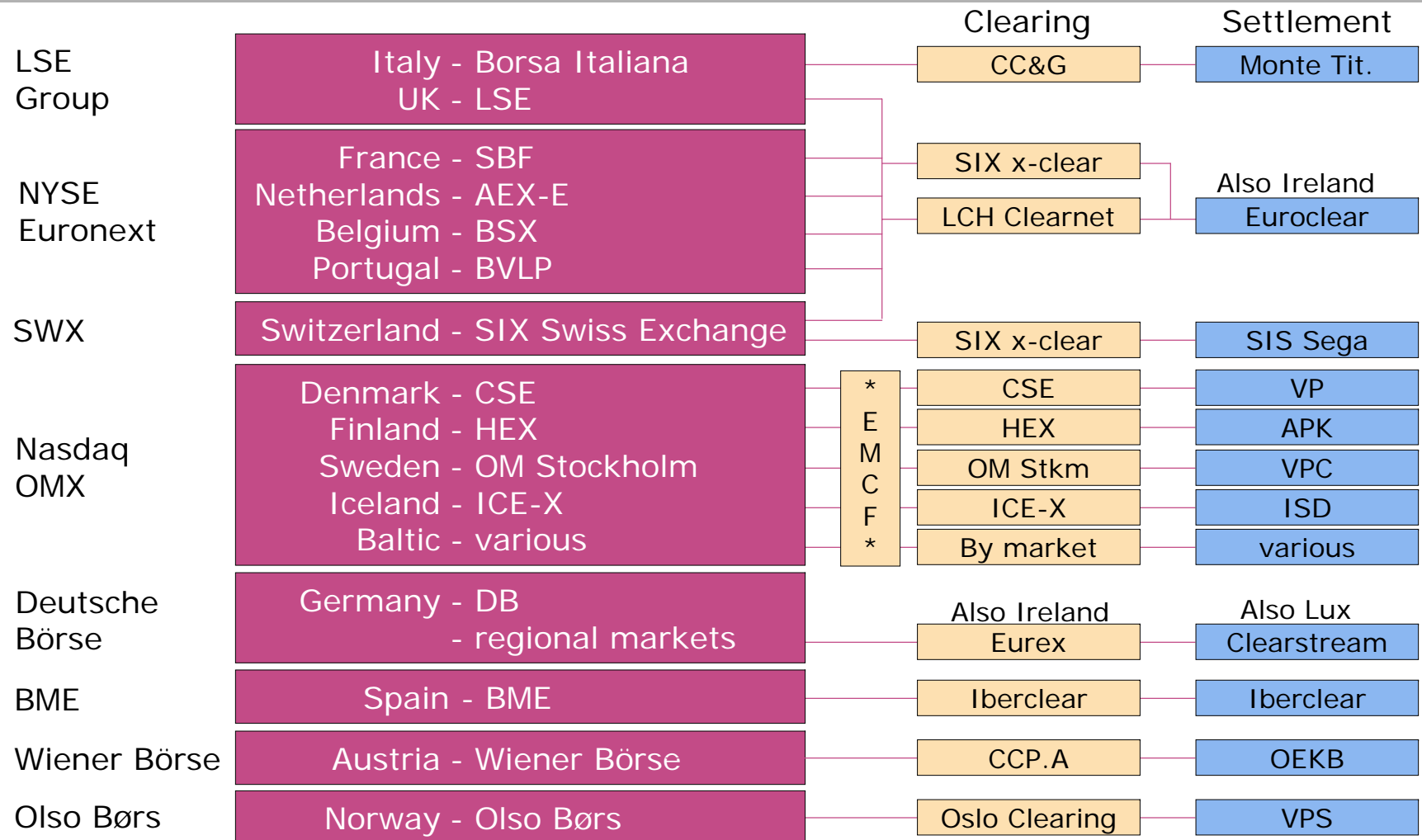
- Trade on an “organised, frequent and systematic basis”
- Matches proprietary trades and client orders without going to a regulated market or MTF
- Must
 - quote liquid shares binding up to a threshold
 - give external participants opportunity to trade
 - provide quotes throughout the day

Systematic
internalisers:

as at May 2009

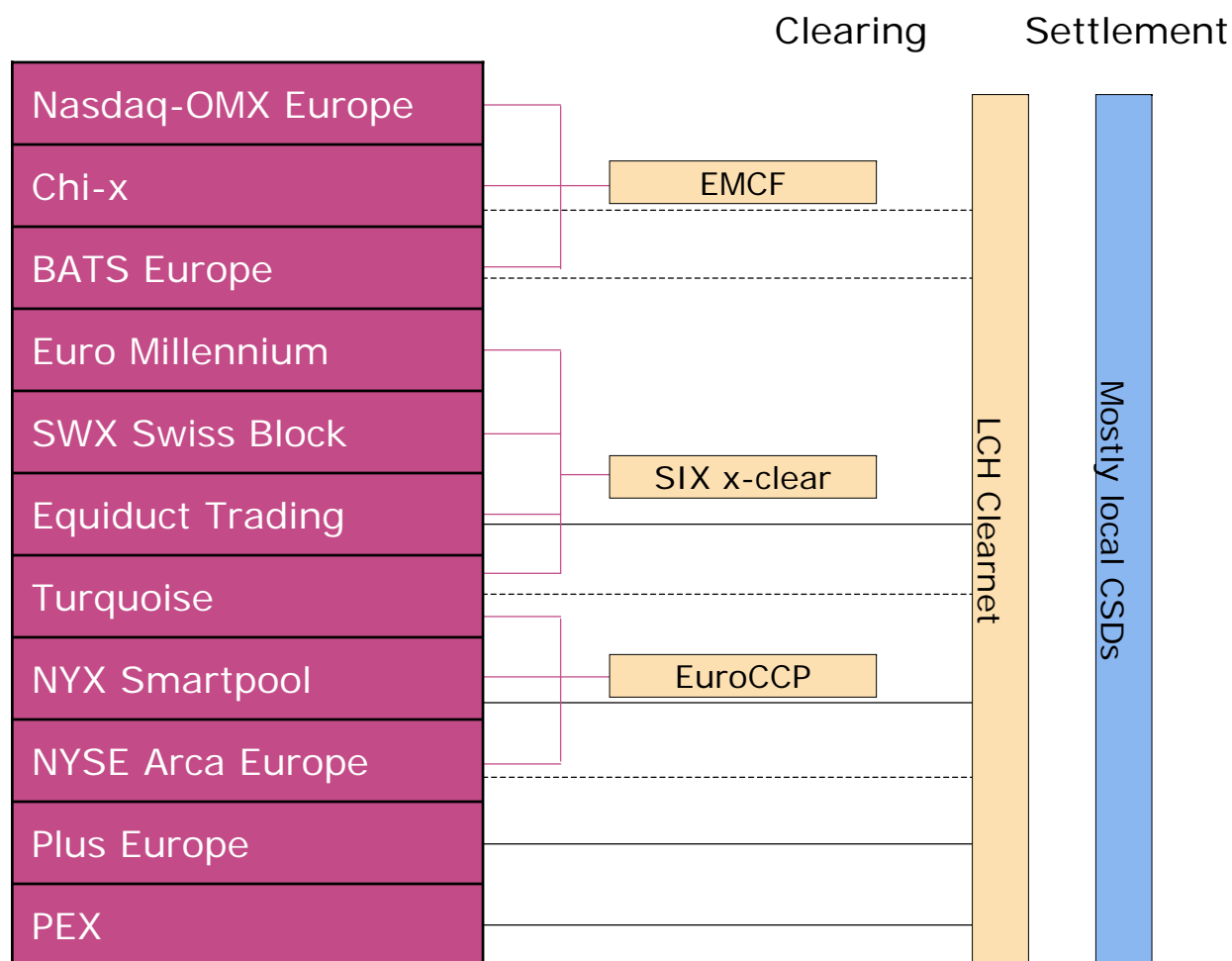
ABN Amro	Danske Bank	Nomura
BNP Paribas	Deutsche Bank	Nordea
Citigroup	Goldman Sachs	UBS
Credit Suisse	Knight Equity Mkts	

Current position – Clearing and settlement



* Phased transitioning to EMCF March-Oct 2009

Current position – Clearing and settlement MTFs



The "biggest outstanding issue is clearing. However if traditional players cannot resolve [the problem] new entrants will..."

Larry Tabb,
TABB Group

Current position – Clearing and settlement

- 23 Central Securities Depositories (CSDs) organised largely on national lines
- Multiple central counterparties or (CCPs)
 - CCPs aligned with each of the major exchanges
 - others popping up to serve new execution venues
- Highly complex costly system that affects margins
- Initiatives
 - the Code of Conduct's interoperability guidelines
 - TARGET2-Securities or "T2S"
 - Link Up Markets CSD joint venture

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Next? – More European MTFs

Launch	MTF	Market	Owners/sponsors	Dark/Light
May 09	Neuro Dark	Europe	Nasdaq OMX	Dark
Q2 09	Chi-Delta	Europe	Instinet Europe, Nomura	Dark
Jun 09	Burgundy	Nordics	Consortium of Nordic banks and brokers	Light
Sep 09	Quote MTF	Europe	BRMS Holdings/ AboveThirty	Light
2009	Baikal	Europe	London Stock Exchange	D/L
Q4 09	Xetra International	Europe	Deutsche Börse	Dark

- How many more to come?
- May be too many for available volumes
- May take share from the Exchanges
- May take share from each other

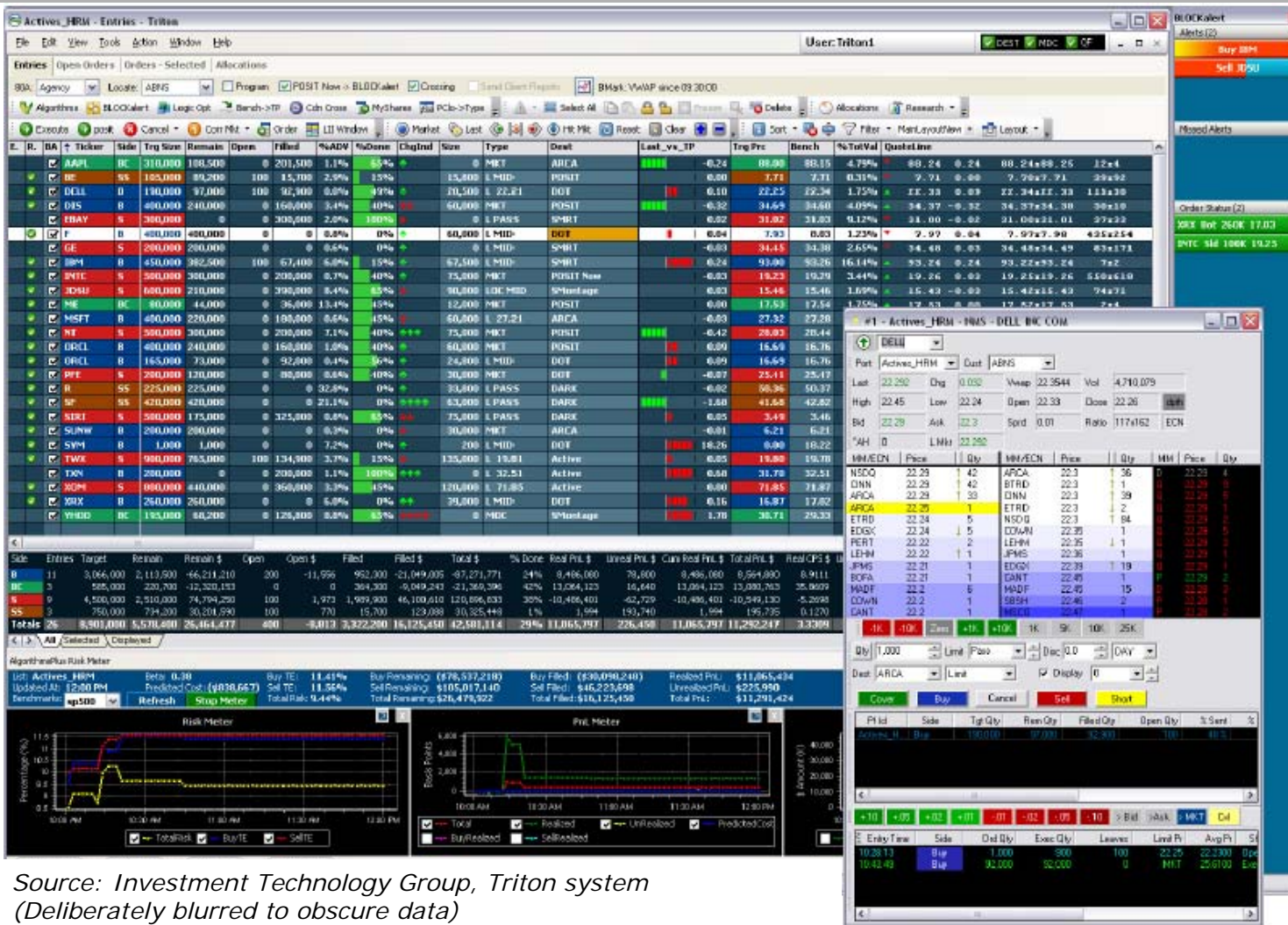
Next? – IR Impact

- Sell-side role evolving
 - advise and service rather than market and inform
- Buy-side role evolving
 - direct market access
- Increased trading velocity
- More difficult to explain price and volume
- Less price impact when large blocks change hands

"DMA accounts for 8% of total trades at present and is expected to grow to up to 20% by 2010."

Deutsche Bank

Trader's "cockpit"



Source: Investment Technology Group, Triton system
(Deliberately blurred to obscure data)

Appendix - Jargon

Algorithms	Computer programs that break up trades and place the pieces separately
ATS	Alternative trading systems. Usually (1) electronic communications networks and (2) crossing systems
CCP	Central counterparty
CSA	Commission sharing agreements
CSD	Central securities depository
Dark pools	Trading venues which do not display quotes
DMA	Direct market access. Ability to trade without using sell-side
ECN	Electronic communications network
EMS	Execution management system
FIX	Computer communication protocol
High touch	(Also Hi touch) Sell-side salespeople and analysts have close working relationship with buy-side
Low touch	(Also Lo touch) Little contact between sell and buy-side, mostly electronic trading
MiFID	EU directive: Markets in Financials Instruments Directive
MTFs	Multilateral trading facilities
RMs	Regulated markets
SIs	Systematic internalisers
Softing	Costs of research, computer services, rent, travel, entertainment (and other services) borne by sell-side and recharged to buy-side as part of trading costs
OMS	Order management system
OTC	Over the counter. Trade that does touch a regulated market
TCA	Transaction cost analysis
Unbundling	Trading costs split between trade execution only and charges for research and other services

Biographies

Marian MacBryde

Marian MacBryde is a founding partner and the finance director of Makinson Cowell. She is also a member of the UK Accounting Standards Board's Urgent Issues Task Force. Between 1981 and 1989 she was an investment analyst at Hoare Govett, specialising in the unlisted securities market. She qualified as a chartered accountant with Ernst & Young.

Peter Kirkow

Peter Kirkow, partner, joined Makinson Cowell's Continental European team in September 2001, following previous advisory and investment banking positions in London. Peter started his early professional career in academia, specialising in East European transition economies. He holds an MSocSc and PhD in Russian and East European Studies from the University of Birmingham, following earlier studies at Berlin (West) and Moscow State University.

Joe Kist

Joe Kist heads equity marketing and road shows for the US team, which he joined in 1998. Joe has over 10 years' experience positioning companies with institutional investors. He developed the firm's US investor database which he continually enhances. He holds a BA degree in communications from the University of Massachusetts.

Thomas Weerheim

Thomas Weerheim joined Makinson Cowell in October 2006 from Alliance Bernstein, where he was part of the Fixed Income Operations team. He previously worked for I/B/E/S and Thomson Financial. He studied International Management at the Rotterdam Business School of Economics, and English Law at the Open University. Thomas speaks Dutch, French and German.