## IR Implications of the New MiFID Trading Environment

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

18 May 2009



MAKINSON COWELL



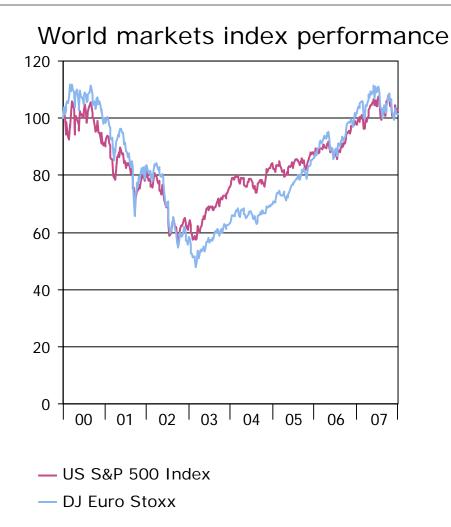
Pressures for change

Evolution

Current position

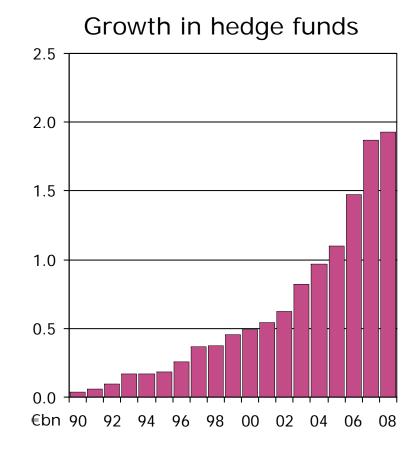
Next?

### Pressures for change – Market performance



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

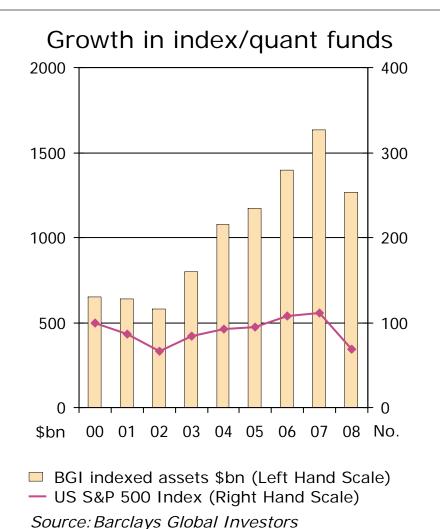
## Pressures for change – Hedge funds



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



- 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

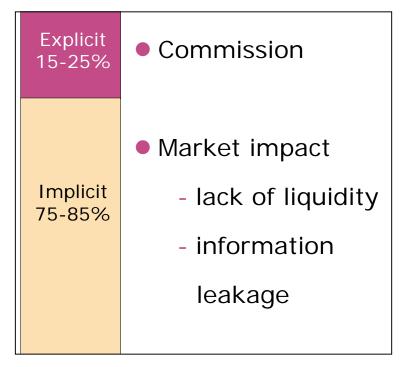
#### Commission

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

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

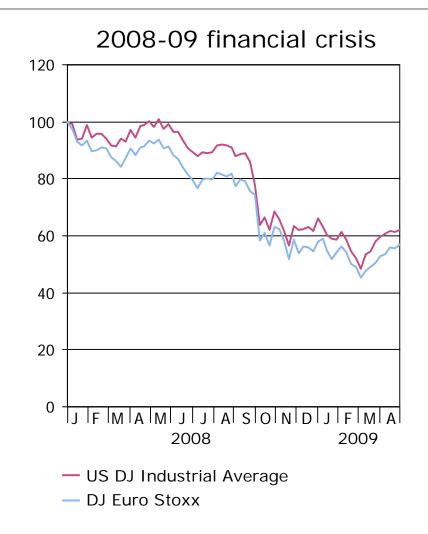
## Pressures for change – Transaction costs

#### 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



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# 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

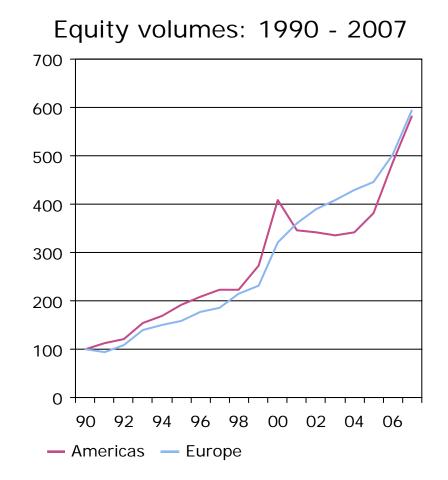


Pressures for change

Evolution

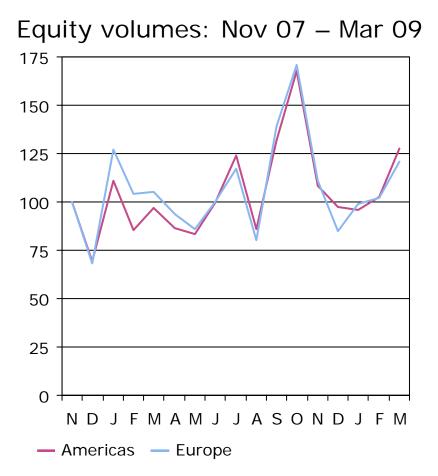
Current position

Next?



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

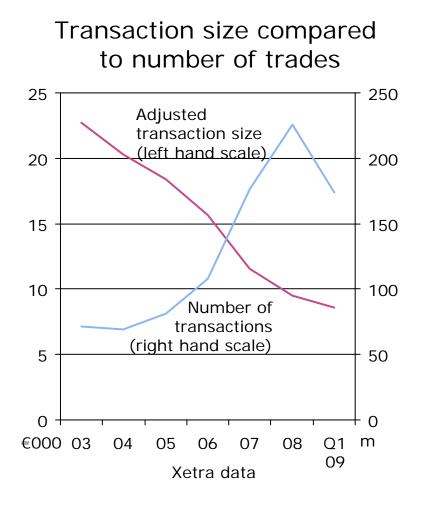
Sources: World Federation of Exchanges, value of cash equities adjusted by price indices and rebased, Europe includes ME and Africa.



- 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.

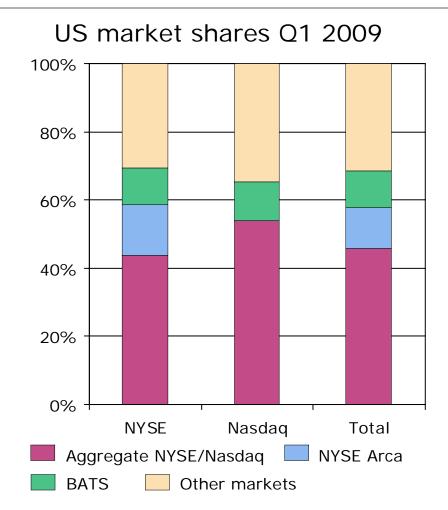
- Slicing bargains into smaller pieces reduces market impact
- New technology divides and routes orders to achieve best execution
- Many more markets and prices where part of a trade can be executed
- Block trades need not be outside the spread
- Bargains may be spread through the day to spread risk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



- 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 nontraditional 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 buyside firms
  - but requires investment
- Smaller brokers
  - IT may be too expensive
  - but receive income for research via commission sharing agreements



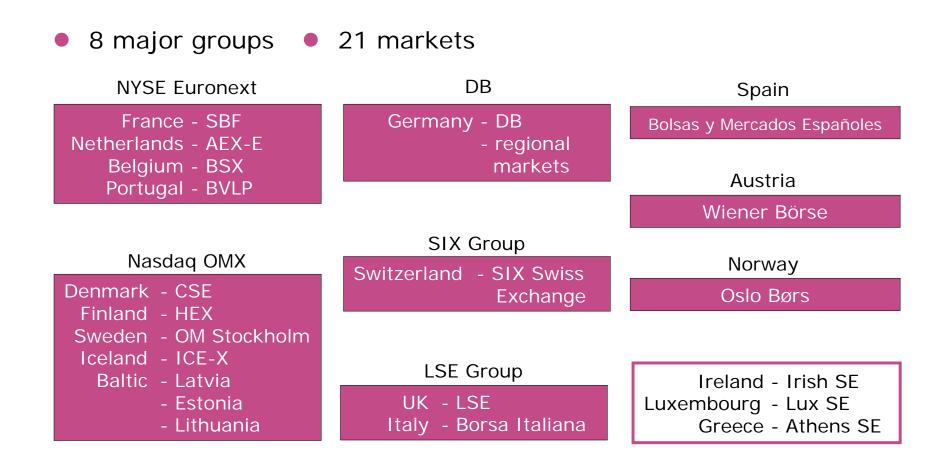
Pressures for change

Evolution

Current position

Next?

## Current position - regulated markets



# 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
	MiFI			
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

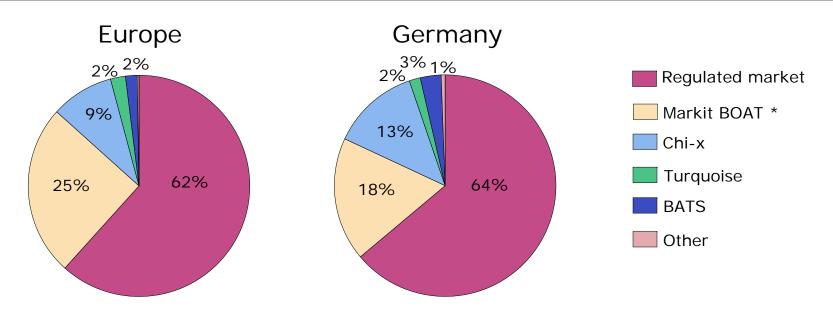
Broker internal crossing

also called internalisation

 orders received or directed through internal networks & matched

 both retail and institutional

## Current position – MTF share of trade



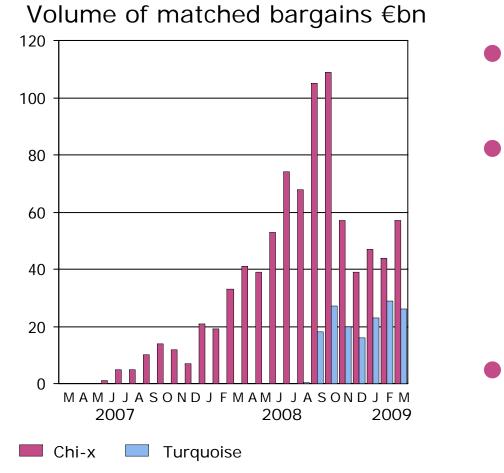
MTF share in Europe is about 14%

#### 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

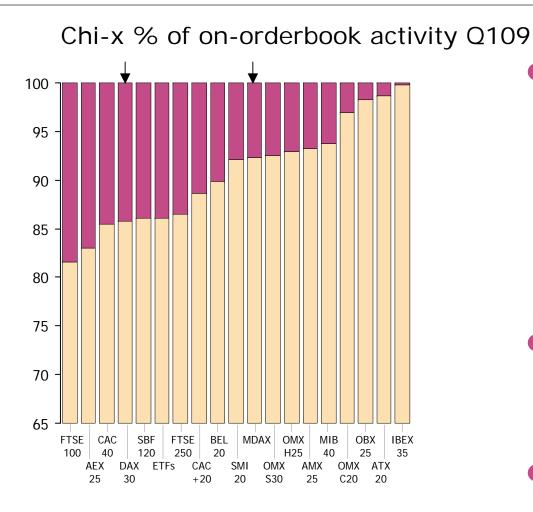
Source: Fidessa Fragmentation Index, Makinson Cowell estimates

## Current position – Chi-x and Turquoise



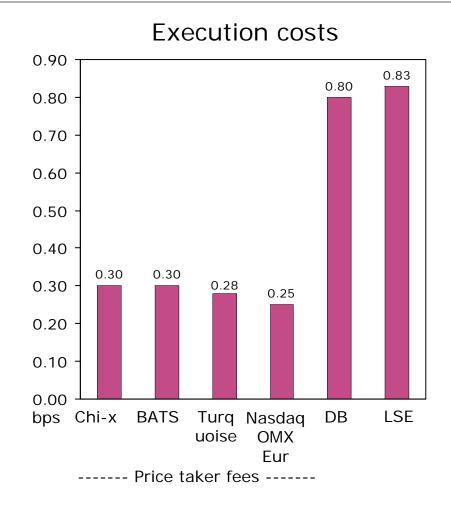
- Pan-European matching engines
- Chi-x
  - small orders visible
  - large orders dark
  - Chi-Delta small orders dark
- Turquoise
  - small orders visible
  - large orders dark

## Current position – Chi-x and Turquoise



- 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

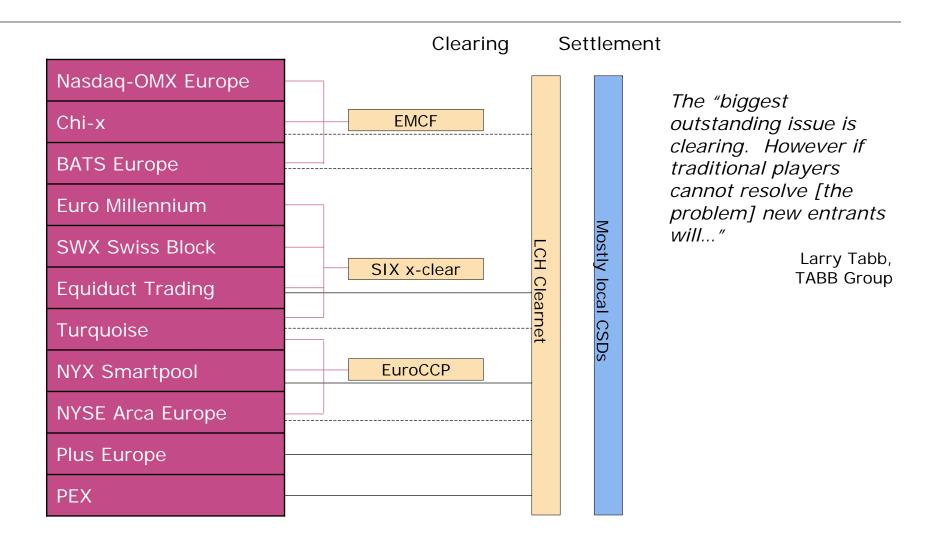
Systematic	ABN Amro	Danske Bank	Nomura
internalisers:	BNP Paribas	Deutsche Bank	Nordea
as at May 2009	Citigroup	Goldman Sachs	UBS
	Credit Suisse	Knight Equity Mkts	

## Current position – Clearing and settlement

		1	Clearing	Settlement
LSE	Italy - Borsa Italiana		CC&G	Monte Tit.
Group	UK - LSE			
NYSE	France - SBF		SIX x-clear	Also Ireland
Euronext	Netherlands - AEX-E Belgium - BSX		LCH Clearnet	Euroclear
	Portugal - BVLP			
SWX	Switzerland - SIX Swiss Exchange		SIX x-clear	SIS Sega
	Denmark - CSE	*	CSE	VP
Nasdaq	Finland - HEX	— E M	HEX	АРК
OMX	Sweden - OM Stockholm		OM Stkm	VPC
	Iceland - ICE-X	F	ICE-X	ISD
	Baltic - various	*	By market	various
Deutsche	Germany - DB		Also Ireland	Also Lux
Börse	- regional markets		Eurex	Clearstream
BME	Spain - BME		Iberclear	Iberclear
Wiener Börse	Austria - Wiener Börse		CCP.A	ОЕКВ
Olso Børs	Norway - Olso Børs		Oslo Clearing	VPS

\* Phased transitioning to EMCF March-Oct 2009

#### Current position – Clearing and settlement MTFs



# 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



Pressures for change

Evolution

Current position

Next?

# 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"

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# 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
ССР	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
ОТС	Over the counter. Trade that does touch a regulated market
ТСА	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.