COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
EUROPEAN PARLIAMENT

Public Hearing on 5 December 2011

MiFID Review: objectives for MiFID/MiFIR2

Scope: learning lessons since MiFID1
"Are the right institutions, services/activities, venues and instruments captured?"

Finance Watch would like to thank the Committee on Economic and Monetary Affairs of the European Parliament for its invitation to participate in this hearing.

When addressing the question asked today, I will have in mind the objective stated for the MiFID revision of being "an integral part of the reforms aimed at establishing a safer, sounder, more transparent and more responsible financial system working for the economy and society as a whole."

Let us look into whether MiFID has succeeded in improving the ability of capital markets to fulfill their essential function of making the demand for capital from the real economy meet the supply of capital from genuine investors.

We will look into this question following what we think are the three essential criteria underlying this question: has MiFID1 contributed to a capital allocation process done 1) in a transparent manner, 2) at the best possible price (including transaction costs) and 3) with a consequence of serving the economy and society?

1. Transparency

Despite varying measures of its actual size, it is usually accepted that around 40% of European equity volumes are traded OTC whilst so called "dark pool" volumes represent about 6% of equity trading. This means that about 46% of European equity market volumes offer no pre-trade transparency.

It was also estimated by the Goethe - Universität Frankfurt in November 2010 that 39.35% of all OTC trades in EURO STOXX 50 constituents are below or equal to the MiFID "retail size" of 7,500 €, that a further 8.77% of all OTC trades are between the retail size and their respective "standard market sizes" (i.e. that, in total, 48.12% of all OTC trades are below or equal to standard market sizes) and that 39.03% of all OTC trades are between "standard market size" and "large in size" ("large in size" being the level that effectively waives the requirement to publish pre-trade data under MiFID 1 rules). This means that 87% of OTC transactions (which by definition offer no pre-trade transparency) violate the spirit of MiFID1 on pre-trade transparency, if not its letter due to a weak definition of OTC.

Can a market where such a large proportion of transactions offer no pre-trade transparency still be considered as providing the information necessary to an efficient price formation process? This is a very serious concern as this situation could lead to question the meaningfulness of market prices and, as a consequence, the very economic usefulness of markets.

2. <u>Best possible price (including transaction costs)</u>

MiFID has led to market fragmentation, which in turn has led to an average 50% decrease of the average size of transactions as many of them now require to be executed on several trading venues.

Finance Watch has not had the opportunity to research by itself the impact that this fragmentation of markets and orders has had on transaction prices and costs but it takes note of the fact that the report published by the CESR in June 2009 (*"Impact of MiFID on equity secondary markets functioning")* stated that market fragmentation and the significant decrease of quantities available at the best price on each single trading venue linked to algorithmic trading "has led to a higher number of executions on multiple venues required for the execution of one order which ultimately increases costs of trading".

The same report also stated that if MiFID had actually led to a decrease of transactions costs, this decrease had been absorbed to a large degree by financial intermediaries rather than passed on to end-investors and that, in any case, it had not been sufficient to absorb the increase of transaction prices, hence leading to an increase in the total net price paid by end-investors for a transaction.

3. <u>Serving the economy and society</u>

Competition among trading venues has led to the creation of MTFs and market fragmentation. This, in turn, has accelerated the development of high frequency trading (HFT) both on MTFs and on traditional regulated markets. Today, HFT represents 35% of European equity trading volumes.

HFT, as we know, is a sub-set of algorithmic trading and has many different sides to it: arbitrage of price differences between different trading venues, trend following, market making, but also strategies based on an unequal access to price information and speed of execution and, in some cases, direct market abuses such as quote stuffing, spoofing etc…

A distinction must be made between HFT that creates liquidity and HFT that creates volume: only market making related HFT can be argued as bringing liquidity to the market whilst all other forms of HFT only create volume as witnessed by the now famous "flash crash" incident of May 2010 on the US market during which several billion dollars' worth of equity index products changed hands 27 000 times in 14 seconds leading to a market collapse. Contrary to what has been said, this incident was not only about rogue algorithms but, much more importantly, demonstrated the fact that the bulk of high frequency trading is about trend following strategies that not only do not bring any liquidity to the market but have a natural tendency to reinforce artificially pre-existing trends. This is also true in the daily routine of financial markets even when such strategies do not lead to a market crash.

With the exception of market making related activities and, possibly, arbitrage of price differences between different trading venues, all the other high frequency trading strategies have the mechanical effect of going against genuine investors' ability to execute transactions at the best possible price for them. In speaking with institutional end-investors, Finance Watch has even gathered anecdotal evidence that HFT has a "crowding out" effect for them as it competes with genuine order flows and effectively withdraws liquidity.

Paul Lee, from Hermes Equity Ownership Services Ltd, was recently quoted in the *Financial Times* as saying: "*You see some activity - high frequency trading is just one example of it - where agents are frankly serving their own interests rather than the interests of end users. […] "We need to get back to a market that works more efficiently in the interests of the users and providers of capital. That is one that is much less about trading activity and much more about underlying companies; investing in companies as if they were companies rather than providers of share chips in a casino*". Finance Watch is in agreement with that statement.

Conclusion

Finance Watch's view is that MiFID 1, despite its stated intentions, is far from having reached the objective of improving market fairness, transparency, liquidity and price competitiveness with a view of improving corporations' access to capital markets and protecting investors.

Finance Watch also thinks that the own initiative report on "regulation of trading in financial instruments" adopted by the ECON Committee of the European Parliament in November 2010 contains several helpful suggestions that should be considered in the MiFID review process.

With the objective in mind of ensuring that our financial system works for the economy and society, Finance Watch will be making concrete proposals on the topics addressed today and on the many others (including investor protection, responsible sales and commodity derivatives) that could not be covered in this hearing.

Thank you.

Thierry Philipponnat, Secretary General of Finance Watch

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