

How sticky is liquidity?

As a lawyer I should be delivering a picture of doom, gloom and despondency. I should be pointing out that there is a lot to do, little time to do it in, Financial Services Authority (FSA) is not doing enough to help, that this is only consultation so the picture presented today could change, or the implementation could be delayed. And by the way you need to hire lawyers and accountants for guidance.

However, I am going to leave that to someone else. I want to take this opportunity to look forward at the post-Mifid future that is emerging even as the directive takes shape. Before that, though, I should note that the timetable for Mifid implementation is very demanding: already some EU member states have outed themselves, admitting they are not going to be ready to implement the directive on time while, historically, FSA's delivery on rule making has been patchy.

Background

With FSA just meeting their promised delivery date for their main consultation on Mifid implementation on 31 July (CP 06/14), we now have a lot of information on how the UK markets will look post Mifid. We have:

- ❑ the directive itself,
- ❑ the level 2 measures (only 17 of Mifid's 73 articles are subject to further elaboration at level 2),
- ❑ the Treasury's vision for the revised Financial Services and Markets Act in its consultation issued in December 2005, with summary responses issued in May this year,
- ❑ FSA's thoughts on what best execution should look like (DP 06/03).
- ❑ FSA's ideas on organisational systems and controls (CP/09).

How the post-Mifid UK financial markets will look is likely to be significant because just as the US

markets tend to lead the rest of the world, the UK markets seem to be leading the rest of Europe. My reasoning here is first; anecdotally, the UK has as many financial service regulators as the rest of the EU put together and; secondly, the UK has apparently made more progress towards implementing Mifid than any other EU member state.

The future

Mifid is unleashing forces that are going to revolutionise the way financial markets operate in Europe. From what is emerging we are set to see the end of concentration, the advent of multiple trading venues, greater pre- and post-trade discovery and a general presumption that clients are entitled to best execution.

The revolution waiting to happen in Europe is the same revolution that has taken place in the US over the past several years, where multiple competing execution venues have cut execution time and driven down execution costs. I believe the model presented by the US financial markets probably offers the best vision of the landscape of the post-Mifid European financial markets.

Concentration, which never applied in the UK but applies in many EU member states, is the process under which a member state can require certain transactions to be executed on a particular regulated market. The end of concentration means that, post-Mifid, anyone can offer a facility to trade in any investment.

Post-Mifid there are going to be three recognised types of execution venue: regulated markets (RMs), multilateral trading facilities (MTFs) and systemic internalisers (SIs). An RM is the Mifid equivalent of what, in the UK, is known as a recognised investment exchange while an MTF

is currently known as an alternative trading system. An SI has no current equivalent in the UK but is defined under Mifid as an investment firm which on an organised, frequent and systemic basis deals on its own account by executing client orders outside an RM or MTF.

In addition to these recognised types of execution venue, execution can also take place outside them in the OTC market.

Mifid has great plans for MTFs. Operating one will be a new class of regulated activity, covered by the EU passport, so that an MTF established in one EU member state must be available to users in any other EU member state. Theoretically, anyone who meets the necessary conditions for authorisation in the UK can operate an MTF. This includes exchanges and authorised firms.

There is much discussion about the likely number of SIs post-Mifid. Any organisation which is capable of dealing with its clients from its own book, or matching its clients' orders, and is willing to meet the Mifid rule requirements can become an SI. Of these rule requirements probably the most significant is that the deals executed by the SI are executed on a non-discretionary and continuous basis. The small transaction size in which an SI must deal necessarily limits the activities of SIs to the retail sector.

Transparency in execution

Transparency is a requirement on RMs, MTFs, SIs and the OTC market to make information about the price and depth of their market in shares available publicly. The Mifid disclosure obligations are fairly complex and vary according to the execution venue. An RM, for example, has to give bid, offer and depth information on shares whereas an SI is only required to give the same

Mifid, the new super sized European directive, set to be implemented in November 2007 is beginning to take shape. **Vincent Mercer** explores its evolution

information in relation to the 500 or so most liquid European shares, in sizes below the standard market size. There is also an obligation for trade transparency to the OTC market in shares listed on RMs, which is a radical departure from the current arrangements.

There are a number of waivers to the requirements permitted by Mifid, which FSA is minded to grant, such as large size block trades and cross trades, and negotiated trades subject to certain conditions.

While the transparency requirement will initially be limited to RM-traded shares, and so only likely to be of interest to those involved in equity derivatives, there are wider implications signalled in the consultation papers. The existing FSA rules for transparency for alternative trading systems which apply to non-equity instruments will remain in place. More significantly, the commission is required to report before November 2007 on whether it considers that the scope of the transparency requirements for shares should be extended to other classes of financial instrument. In anticipation of that review, FSA has recently consulted on transparency requirements for the secondary bond market, publishing the feedback in July.

The important point here is not so much the detail of the rules but the principle of full disclosure of what is in, and has been transacted across, the market as a whole.

Best execution

The last of the building blocks is best execution, which in Mifid is termed "the best possible result for [the] client" (Art. 21(1)) taking into account a range of factors. Every firm is under a duty to inform its clients of its execution policy and take "all reasonable steps" to provide best execution to them. Under

Mifid, clients get classified as either retail or professional and the best execution obligation applies to both, so there is no opt out for intermediate customers. Only an "eligible counterparty" – equivalent to a market counterparty – can opt out of best execution.

FSA has clearly spent much time considering how to test whether best execution has been delivered and has come up with a proposal for benchmarking. This is the process by which a theoretical benchmark price would be set and there would be a presumption that any deviation from this benchmark price would give rise to a suspicion that best execution had not been delivered. Unsurprisingly the benchmarking proposal has its critics, such as London Investment Banking Association which apparently recently described FSA's proposals as "unworkable and unwarranted".

The implications of the package of measures being ushered in by Mifid are that anyone who has order flow can set themselves up as an SI, anyone who has a trading platform can become an MTF – and so much the better if your trading platform is quicker and more user friendly than the other guys' – and everyone, even the OTC market, has to disclose their prices, depth and deals.

On the other side, to achieve best execution for its clients a firm is potentially going to have to look at every one of these execution venues. According to FSA, a firm wishing to use only one execution venue or intermediary will need to demonstrate how this satisfies the requirement of taking "all reasonable steps".

Coming unstuck

I suspect that those who really have to think carefully about the implementation of Mifid, typically large investment banks operating across EU borders, have like we

lawyers, been studying the likely post-Mifid shape and considering how they fit into it.

If we look to the US where they already have multiple execution venues and reg NMS – equivalent to the best execution rule – this has it seems led to many houses creating their own electronic crossing networks. It has also seen the development of new execution platforms, the acquisition of new trading venues by established players – such as the acquisition of Instinet by Nasdaq and Archipelago by New York Stock Exchange – and overseas exchanges setting up in mainland US. The result is that execution in the US is more efficient and the costs significantly lower than in Europe.

In Europe, pools of liquidity are likely to be under threat from the changes in the post-Mifid world. Step changes in liquidity pools have historically been rare and generally brought about by design or accident, such as the transfer of the Swiss market to Virt-X in London and the repatriation of the Bund futures market to Frankfurt. Liquidity is often described as sticky as it will stay where it has developed, with market users not looking to trade elsewhere. Post-Mifid the question is whether these pools of liquidity will fragment with the development of multiple execution venues and market users forced to at least look at alternative trading venues. Furthermore, to what extent those less efficient trading venues with pools of liquidity will be overtaken by better, quicker and more cost effective execution venues or simply transplanted by firms who will internalise transaction will also be questioned. Post-Mifid we will find out just how sticky liquidity really is. □

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