

Response to Call for Evidence

9 January 2009

Börse Berlin --- Equiduct Trading

Equiduct - Introduction

We would like to thank CESR for this opportunity to present our views regarding the impact of MiFID on secondary markets functioning.

Equiduct is a trading platform operated by Börse Berlin that currently distributes consolidated market data and that will soon offer trading services to its participants on the basis of these consolidated prices. The Equiduct initiative is a response to the new regulatory framework that has been created by MiFID, notably in relation to the “best execution” obligation.

While there are many aspects of MiFID’s impact on secondary markets that are worth discussing, we would like to focus in this response on the two areas where we differentiate ourselves from other regulated markets, MTFs or data consolidators, namely the use of a consolidated benchmark price and the access to multiple clearing facilities:

- Equiduct’s Orange VBBO is a de facto “consolidated tape” for European liquid shares. It provides an objective and reliable benchmark against which execution quality can be measured. It is also the price against which trades on Equiduct’s PartnerEx segment are automatically executed.
- Equiduct’s clearing and settlement strategy is based on the premise that there is nothing to be gained from further fragmenting clearing liquidity, since this increases the connectivity, margin and collateral costs for participants. As such, Equiduct seeks to offer access to the main existing pools of clearing liquidity, with a possibility to choose the most appropriate clearing provider or override clearing altogether in instances where established relations favour such an approach.

Equiduct’s “Consolidated Tape”

MiFID requires investment firms to route orders to those execution venues that consistently offer “best execution”. For retail clients, “best execution” generally equals execution at “best price”, unless the client specifically selects a particular execution venue.

In the absence of an established “consolidated tape”, Equiduct has first set out to build a quality benchmark price. In order to do this, it has built a state-of-the-art electronic system for capturing incoming reference data and producing a benchmark price (the Orange VBBO or Volume Weighted

Best Bid and Offer) at Retail Market Size and Standard Market Size. It has partnered with a leading provider of ultra-low latency market data to ensure that its benchmark price reflects the current market situation up to the millisecond. As such it processes peaks of over 100,000 incoming market data price updates per second, resulting in the distribution of more than 12,000 VBBO updates per second. It is able to handle multi-currency reference prices which are converted through the highest quality F/X feed. Contrary to certain other -less sophisticated- “consolidated screens”. Equiduct validates the incoming data on quality first. As such, an execution venue must first prove that it contributes in a “meaningful” manner in the overall price formation process, before its prices will be included in the real-time benchmark price for a particular security. In addition, the price forming mechanism of the execution venue must ensure that prices are relevant, executable and are frequently updated. Equiduct currently publishes the real-time VBBO on over 500 European securities through the major Data Vendors and on its website. With the OrangeVBBO as a consolidated best price, Equiduct can demonstrate the value of including all relevant execution venues in a firm’s execution policy as shown in the example of the Orange VBBO versus the best price on individual markets below:

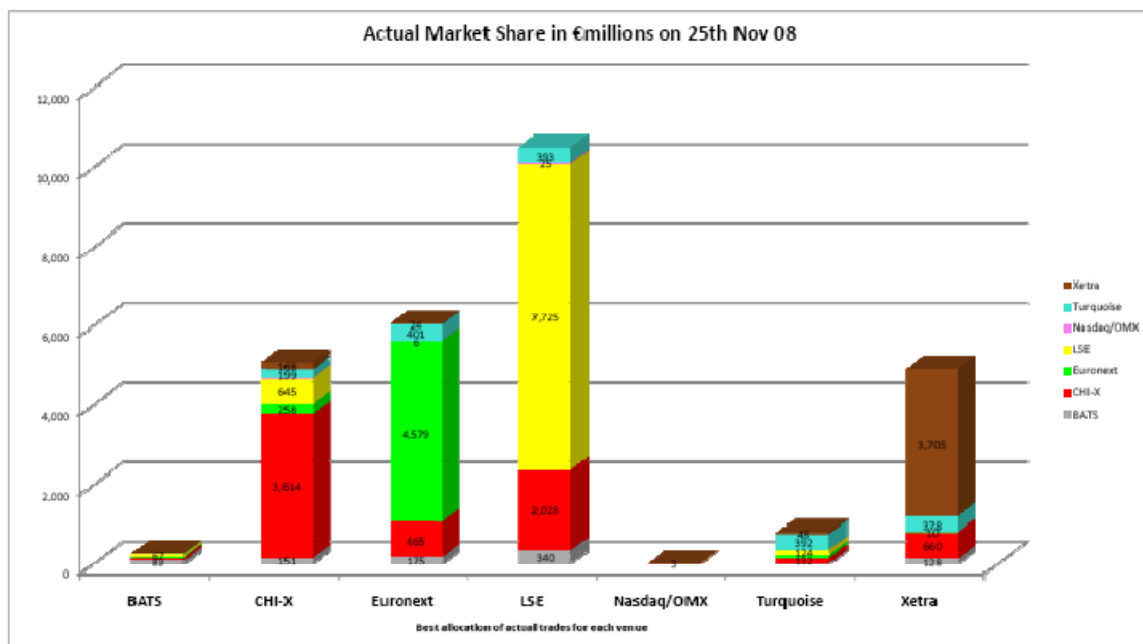


Fragmentation is a reality – but important market imperfections remain

Equiduct is producing trade data analytics with tools that allow it to accurately monitor the market situation on a consolidated basis using the available and accessible pre-trade information published by a range of execution venues. Equiduct uses this data to perform statistical analysis which will be made available to its customers and other interested parties. On the basis of this analysis, Equiduct can confirm that liquidity fragmentation is a reality. This is certainly one of the very tangible

consequences of the introduction of MiFID as of 1 November 2007. MiFID not only led to the lowering of trading fees at the incumbent exchanges through the creation of competing low cost-venues, but also produced tangible benefits for investors in the form of the availability of better prices (narrower spreads) on alternative markets versus the prices available on the incumbent exchanges. We will demonstrate this through a number of graphs.

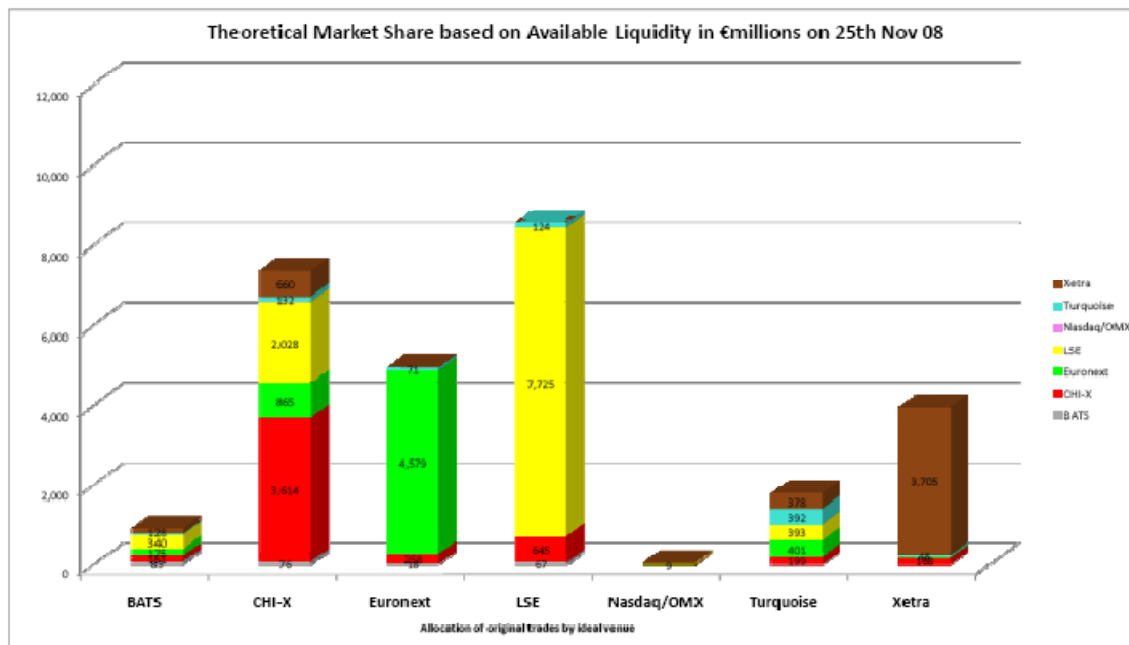
The first graph below shows the total volume executed in the 500 most liquid instruments (listed on Euronext, LSE or DBAG) across the most important execution venues on the most active trading day of last year (25 November 2008). This graph confirms – as is common knowledge by now – that fragmentation is a reality and that some of the new entrants, and especially Chi-X, have managed to capture a significant market share. However, the graph below also shows that trades are not always executed at the most appropriate venue. For example, a significant portion of trade executions on Xetra, LSE and Euronext *should have been executed* at Chi-X if the investment firm had opted to execute the trade at the best price at that moment in time (demonstrated by the red blocks in the graph below). Likewise, a (smaller) portion of trades that were executed on Chi-X should actually have been executed at one of the incumbent exchanges or one of the competing MTFs.



The amount of order-flow that is thus “mis-directed” is significant. If all the trades had been routed to the execution venue that displayed the best price at the time of the order, then investors would have saved on average EUR 1.33 on every trade or EUR 3.5 million in total for that one day (note that we are looking only at the most liquid instruments and that the discrepancies are likely to be even higher for less liquid instruments).

It also means that the visible fragmentation as shown in the graph above, understates the fragmentation that would materialise if orders were routed correctly in accordance with a strict application of best execution rules on an order-by-order basis. The second graph below shows that

the volume on Chi-X and its market share would in that case be much higher than it is today (46%). It shows where the additional volume would come from and as such is a mirror-image of the first graph above. Similarly it shows that the marketshare of BATS, Nasdaq/OMX and Turquoise would respectively increase by 240%, 390% and 124%.



We believe that the reasons for this relatively poor execution performance are manifold and we will cite only the most important here:

- (i) Lack of a trusted benchmark, making it difficult or expensive for investors to ascertain execution quality and facilitating lack of clarity on post-trade performance analytics by banks and brokers;
- (ii) Slow adoption of Smart Order Routers (“SORs”) and great divergence in the type, algorithm and available connections of such SORs: while all SORs seek to ensure best execution, every SOR has its own definition of best execution and not all SORs have access to the same universe of execution venues in which best execution is defined;
- (iii) General lack of interest from the retail investors in execution quality: while retail investors are sensitive to a difference in a broker commissions of as low as 1 euro and would swap brokers to achieve that saving, they are much less sensitive to a difference in execution quality that could lead to savings of a multiple of that amount; as a direct result, retail brokers in Europe currently do not compete on execution quality (since they have no incentive to do so), but only on costs/commissions charged directly;
- (iv) Divergent interpretations of “best execution” by home country regulators (some of which continue to blindly support automatic routing to home exchange as sufficient evidence of best execution) and lack of enforcement actions that might persuade

intermediaries to expand the scope of the execution venues they take into account in determining their execution policies.

Barriers to a pan-European level playing field in relation to market transparency

Apart from the problems identified above, that could to a large extent be addressed through harmonised interpretative guidelines of CESR and proper local enforcement actions, there are a number of areas that have not been addressed by MiFID in terms of price transparency.

Although the legal nature of the market data that is distributed by the exchanges is a matter of dispute, it is clear that – to date - this data is controlled very strictly by incumbent exchanges through their contractual agreements with data vendors and data customers and it remains an important source of income for these exchanges which they naturally seek to protect. Most of the new entrants have taken a different approach – acknowledging that the market data is in the end produced by their participants who should thus profit from it. As such, data by new MTFs is mostly distributed for free or is rebated in one form or another to the participants.

The restrictive pricing and contractual policies of the exchanges do not allow for a normal commercial exploitation of a consolidated tape that shows the various underlying feeds. In fact, a consolidated price feed that comprises data from LSE, Deutsche Börse's Xetra and Euronext alone, would cost the multiple of the feeds of these three exchanges or EUR 332.5 per month at least (LSE: £157.5; Euronext: €90; DBAG + European Stars: €76), without taking into account the cost for producing the consolidated feed (including costly annual license fees to be paid to the incumbents). Full list prices have to be paid per single user of such a consolidated feed, independent of the fact that one of the data sources may contribute only 1% of the consolidated feed (e.g. Xetra European Stars contribution to price formation in CAC40 shares). This is different from the US consolidated tape practice, where a reasonable consolidated tape price is determined first (at a fraction of the price mentioned above) and the revenues are then shared amongst the exchanges that contribute in proportion to their contribution (i.e. in proportion to the quality of their their liquidity in the underlying stocks).

The stranglehold of the European incumbent exchanges and their refusal to move to an alternative fee system for consolidated tape products, seriously hinders the commercial initiatives of market data providers in this area as well as the uptake of those products by (professional) investors. In fact, consolidated price products where the underlying prices of the exchanges are visible (as offered by most major data vendors including Bloomberg, ThomsonReuters and Fidessa) are currently mostly used by those professional firms that already pay monthly data fees for all of the underlying feeds that make up the consolidated data product, meaning that the benefits of increased cross-border pan-European competition are not reflected in a better exposure to pan-European pre- and post-trade transparency. Moreover, most of the providers of consolidated feeds only offer such feeds as part of other “bundled” services.

A mandated “Consolidated Tape”?

The incumbent exchanges, and notably the LSE, have been very vocal in resisting regulatory intervention in the area of market data consolidation. We agree with the LSE that there is currently no need for a heavy handed regulatory intervention that would seek to install a US-style government regulated utility to produce or distribute a consolidated tape. The market only stands to gain from allowing competing providers to offer competing benchmark products, where the industry will ultimately select the most appropriate standard on the basis of the price and quality of the benchmark. As such, Europe has the ability to develop a more sophisticated market model than the one-size fits all model imposed in the US, that would moreover cover full depth-of-book data rather than the restricted top-of-book data regulated under the RegNMS system.

However, we do not agree with the LSE that no action at all is needed in this area. As various participants - and notably the buy-side community - have already expressed, the current status quo does not allow for the benefits of MiFID and increased competition amongst execution venues to be enjoyed equally by all investors.

MiFID has acknowledged the importance of consolidation of price information in the face of increased fragmentation of trading. Articles 44 and 45 of MiFID therefore require regulated markets to give access to their pre- and post-trade information “on reasonable commercial terms and on a non-discriminatory basis”. This is repeated in article 32 of the Commission Regulation (EC) 1287/2006 of 10 August 2006 which adds that the publication “must facilitate the consolidation of the data with similar data from other sources”. These provisions form a sufficient legal basis for the issuance of guidelines and recommendations by CESR that interpret these broad based provisions in a meaningful manner and that shed light on the current commercial practices of the incumbent exchanges in relation to consolidated data products. These guidelines and recommendations should go beyond the CESR advice 07/034 of February 2007 in this area, which established some useful guidance in terms of technical consolidation, but did not provide any clarity on the commercial policies adopted by the incumbent exchanges. In reality, the incumbent exchanges have further restricted the use of their data since the entry into effect of MiFID on 1 November 2007 and have imposed additional fees on entities that want to produce a consolidated feed.

In our view, current market data policies of incumbent exchanges at least go against the spirit of the aforementioned MiFID provisions and implementing regulations and the market would therefore benefit from more detailed CESR guidance in this matter. In addition, the consolidated tape currently provided by various data vendors are part of “bundled services” which contravene the Guideline number 9 of the CESR advice 07/034 although the latter only applies to RMs, MTFs and investment firms and not to data consolidators themselves.

Barriers in relation to clearing services

MiFID has sought to improve the level playing field in the post-trade environment, by stating that Member States should not prevent a market operator or MTF from accessing a CCP or settlement system in another Member State. MiFID further states that “in order to avoid undue duplication of control, the competent authority *shall take into account* the oversight/supervision of the clearing and settlement system already exercised by the national central banks as overseers of clearing and

settlement systems or by other supervisory authorities with competence in relation to such systems.” The latter statement is extremely vague and is consequently applied very differently in the various Member States.

There is no harmonised European legal framework for clearing services and the providers of clearing services are regulated in accordance with the domestic law of the Member State(s) where they are incorporated. In some Member States clearing and CCP services can only be offered by a bank; in other Member States there is a “sui generis”-regulation for clearing providers. Even if the clearing services are offered by a bank, the EU banking license does not extend to these services.

As a result, faced with a non-domestic provider of clearing services, each Member State will apply its own policy and will interpret the MiFID obligation to avoid undue duplication of oversight in its own manner. As such, while the large majority of Member States simply rely on the Home State authorisation and supervision, supplemented as the case may be by an information sharing agreement or Memorandum of Understanding with the Home State competent authority, some Member States argue that a non-domestic provider of clearing services to a domestic MTF or market operator, must obtain an additional license in that country, even if that clearing provider does not provide services to market participant located in that country. It is clear that this approach seriously undermines the harmonisation efforts of MiFID and the Code of Conduct on Clearing and Settlement, as it considerably increases the cost for accessing non-domestic CCPs and/or the time required to obtain regulatory clearance for such access. We would suggest that urgent regulatory intervention is required to ensure a proper interpretation of article 35.2 and article 46.2 MiFID to avoid that further harmonisation and pan-European trading projects are blocked by the idiosyncratic interpretation of these articles.

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In the above, we have tried to highlight what we consider to be two significant issues that have been insufficiently addressed and that reduce the potential beneficial impact of MiFID and the reduction of costs of intra-EU cross-border trading. We are always available for further clarification on the subjects mentioned or on other aspects of MiFID that we have not addressed in this Response.

Yours sincerely,



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