# MiFID & trading

**Nathalie Aubry**, an adviser on regulatory policy, at the International Capital Market Association (ICMA), examines the impact of the EU's Markets in Financial Instruments Directive (MiFID) on trading venues, almost one year on since its introduction

A central element of the EU's MiFID directive is the fostering of an efficient, competitive and liquid European capital market. One key element of the new framework, effective from 1 November 2007, has been to increase competition, notably between trading venues, a provision mainly aimed at established exchanges, such as Deutsche Börse, and to encourage new entrants, such as Turquoise, Chi-X or BATS.

Since the implementation of MiFID, the traditional exchanges, such as the London Stock Exchange, have had to adapt to a new environment that introduces alternative trading platforms, or Multilateral Trading Facilities (MTFs), which have comparable authorisations to exchanges and passports to trade across national borders. The ending of the concentration rule, in countries such as France, has also meant that markets can no longer require orders to be executed at the central national marketplace and monopolies can only be based on competition, rather than on regulation. National borders can no longer inhibit trade.

As far as regulatory provisions are concerned, MiFID classifies trading venues into three explicit categories – Regulated Markets, MTFs and Systematic Internalisers – with the fourth category 'over the counter (OTC) trading' implicitly defined in recital 53 of the directive, covering transactions that are not allocated to one of the first three categories.

The trading venues are defined in MiFID as follows:

• A Regulated Market is a multilateral system operated by a market operator where the instruments traded are admitted according to a defined procedure and the market is authorised, and functions, according to Title III of the directive

• An MTF is also a multilateral system – it can be operated both by the operator of a Regulated Market or an investment firm. MTFs do not have the same obligations concerning financial instruments included into their quotation, and there are no specific requirements regarding authorisation for the operation of an MTF

• A Systematic Internaliser is an investment firm which, on an organised, frequent and systematic basis, deals on its own account by executing client orders outside a Regulated Market or an MTF.

These categorisations define the framework for the new regulatory environment for regulated markets and investment firms, post-MiFID. They affect, among other things, market transparency, market models and competition between trading venues. A market model of a trading venue can be characterised by three key structural elements – trading frequency and price determination; pre-trade transparency; and post-trade transparency.

Although the positive impact of MiFID did seem uncertain at first, nearly one year on, banks have clearly seized the opportunity provided by the directive's provisions. These opportunities were also made possible by technological innovation in the field of algorithmic trading, which can identify the best trading venues and provide a clear audit trail – and therefore allow compliance with the best execution requirements.

Financial institutions are also now offering dark pools of liquidity (i.e. non-displayed trades), or even their own exchanges via projects like Turquoise or Chi-X. The latter, owned by Nomura Holdings' broker agency Instinet, and some 14 other financial institutions, is the first live pan-European equity MTF aimed at taking on the three major European exchanges, with its faster and cheaper trading engine.

Dark pool equity trading platforms, such as NYFIX Euro-Millennium, set up in March 2008, were established with the support of investment banks like BNP Paribas, Citi, Credit Suisse, JP Morgan, and UBS, as well as fund houses such as Allianz, CA Cheuvreux, DWS, Insight, Resolution and Schroders, all of whom act as members of its advisory board. Dark liquidity pools are electronic trading venues that do not quote prices. They match buyers and sellers anonymously, minimising information leakage and market impact, often with lower direct trading costs. Established exchanges, such as the London Stock Exchange, faced with competitive pressure in regard to the provision of liquidity, have recognised the importance of these dark pools. The LSE, for instance, recently announced the creation of a new dark liquidity pool pan-European trading system, called Baikal, in partnership with Lehman Brothers, as a response to the new entrants. Baikal is expected to start operating in the first quarter of 2009. [*As Lehmans has now filed for bankruptcy however, they'll obviously no longer be partners in the project*].

One key remaining area of concern and interest for all parties is the extent to which liquidity in the trading of European equities fragments away from the primary exchanges on which shares are listed. Connecting to multiple trading venues is a significant challenge for most firms. With a proliferation of trading venues and the end of traditional concentrated models, the ability to access the growing number of trading venues, as new destinations emerge with varied offerings, including dark pools, will be of high importance, necessitating increasing amounts of connectivity. This is a challenge for trading firms in the years ahead.