# Innovation
# Competition
# Diversity
# Choice

## A European capital market for the 21st Century

*A position paper prepared by:*


*Association of Private Client Investment Managers and Stockbrokers - European Association of Securities Dealers*

*Futures and Options Association*

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*International Securities Market Association*

*International Swaps and Derivatives Association*

*London Investment Banking Association*

*The Bond Market Association*



*21st May 2002*

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## Executive Summary

An argument has been put forward, by one regulated market, that the way to preserve and improve the quality of Europe's securities markets is to require all orders in securities to be routed to exchanges (regulated markets) for execution. This view of an efficient market bears no relation to today's trading environment. It is a call for a return to the market monopolies of twenty years ago. It is not clear to what extent other regulated markets support this view but, in any case, we reject it.

If Europe adopts such a proposal, liquidity in its securities markets will be severely damaged, the overwhelming majority of investors will receive worse prices and the cost of capital for issuers will undoubtedly rise.

Twenty years ago Europe's securities markets were small, illiquid and parochial. Today, spurred on by the EU's efforts to remove barriers to cross border movement of goods, services and capital, and to promote competition, Europe's securities market is healthier, more efficient and with higher trading volumes than was ever believed possible during the days of national protectionism. These hard won improvements must not be put in jeopardy.

Exchanges have participated in that process. Forced to compete for order flow amongst each other and with investment firms, they now offer an efficient market place for some investors, some of the time. When all investors have orders of similar size, when buyers and sellers are approximately equal and are closely grouped, price-wise, around the mid-price between the best bid and best offer and when investors have no need for immediacy, an exchange's limit order book will be sufficient.

But securities markets are characterised by diversity not uniformity. Each investor is different. Each has, at various times, and for different parts of his or her portfolio, different needs. Stock exchange trading systems do not meet this diversity of needs satisfactorily. The imposition by legislation or regulation of a 'one size fits all' approach will protect neither the integrity of markets nor the interests of investors.

Europe's capital market now accommodates this diversity by offering investors a choice of execution mechanisms and venues. It does not dictate to investors how they must trade. It provides an environment in which those who provide services to investors, be they exchanges, banks, brokers or dealers, must innovate to prosper. It must continue to do so.

If it fails to do so there is a real risk that institutional investors in Europe and elsewhere will route orders in European stocks increasingly to the United States, (where the shares of 240 of Europe's largest and most innovative companies already trade), and issuers globally will withdraw from European markets. They, and the retail investors whose interests they serve, will benefit from the greater range of trading options which will be available there at more competitive prices.

For Europe's aspirations in the global economy, this would be fatal.

To facilitate a sensible debate on the regulation of Europe's securities market and its participants, several myths must be dispelled. The reality is:

- Stock exchange limit order books offer neither full transparency nor equality of information. A published order to buy 1000 shares may be the whole order

of an individual retail investor or part of an order for 100,000 shares being carried out by a UCITS manager on behalf of many retail investors.

- Best execution is not a simple, one-dimensional concept based exclusively on price. Many factors are involved and in each trade a balance must be struck. The Committee of European Securities Regulators (CESR) has recognised this[1].

- Fund managers responsible for the savings of individuals who invest via UCITS and pension funds use in-house dealing facilities of brokers and dealers because that produces price improvement over stock exchange limit order books and minimises damage to the value of any remaining position (the 'market impact' effect). Their clients benefit.

- For retail investors who make their own investment decisions there is no evidence that internalisation results in worse prices. Prices may often be better and commissions lower as a result of operational efficiencies and competition for their business. We acknowledge that this requires investors to more diligently seek out the services that best meet their needs at an acceptable price, but this results in better-informed investors.

- Regulation works. Conduct of business rules, which govern the firm/client relationship and the handling of orders 'in-house', support firms' commercial imperative in maintaining client confidence in the firm and the integrity of the price formation process in the market overall. Modern technology makes verification increasingly cost effective. Harmonisation at the EU level is already under way.[2]

***We urge proponents of the argument that regulated markets should have the sole right to execute investors' trades in securities to recognise that markets and the investors and issuers they serve can only thrive in an open, competitive system. Stakeholders in the success of Europe's securities market - investment firms, investors, issuers, regulated markets, regulators and legislators - should be working together to create a market fit for the 21st century and able to play its full part in achieving the goal of making the EU the world's leading knowledge-based economy by the end of the decade.***

[1] See 'A European Regime of Investor Protection – the Harmonisation of Conduct of Business Rules' (Committee of European Securities Regulators CESR/01-014d), para 102
[2] Op cit

## Background

In January 2002 Euronext published a paper entitled ‘Internalisation’ which attempted to demonstrate that the quality of European securities markets is damaged when transactions take place outside regulated markets. The Euronext paper is flawed because it seeks to impose on the present broad and diversified European capital markets a particular narrow market model which currently operates fairly and efficiently only when certain limited market conditions exist. But a single model cannot possibly cater efficiently for the full range and diversity of needs of users of the market. Nor can it provide the innovation, responsiveness, and competitive discipline which are the true means which serve European citizens’ and businesses’ needs.

The review of the ISD does, as the Euronext paper states, provide an ‘historic opportunity’ for Europe’s markets - to provide an environment for innovative, efficient, fair, internationally competitive European markets. This paper shows how and why existing arrangements, including ‘internalisation’ amongst other market mechanisms, not only do no harm to market users, but provide them with enormous benefits. It also explains the damage which would result from the exclusive imposition of Euronext’s model.

Our point in this paper is not that one type of market is better than another. Entirely to the contrary – European markets work because of their diversity and this diversity is driven by the services investors and issuers demand.

## The monopoly marketplace

The argument set out in the Euronext paper that ‘regulated markets must be used to execute orders for securities’[3] is superficially alluring. Euronext describes a world in which regulated markets, acting in the public good, and competing for order flow, provide the best mechanism for ensuring ‘optimum price formation’ and retaining the confidence of investors.

This is not the real world. While the Euronext analysis may be relevant to a narrow segment of the overall European market (e.g. local retail orders for stocks traded on the local stock exchange), its application to the broader European context is minimal.

Like investment firms, regulated markets are now privatised ‘for profit’ companies whose primary aim is the enhancement of shareholder value. Their ability to act disinterestedly in the public interest is constrained by the need to increase revenue, cut costs, and maximise profits. Eliminating competition may be one way of achieving this. Stock exchanges are no longer the public institutions they were as recently as fifteen years ago. Then the exchanges worked with governments in setting, through statute or regulation, barriers to entry, minimum commissions and market structure. Today, whilst privatised regulated markets contribute positively to a competitive marketplace, acting in the public good is likely to be a priority for only as long as it is perceived to contribute to ‘brand loyalty’.

[3] Page 5 para 4

As to competition for order flow, there is, in fact, very limited inter-exchange competition in Europe. A few stocks have traditionally been cross-listed and trade significant volume on two exchanges; Unilever, Royal Dutch and in recent years, one or two others, such as Nokia, have joined them. But as Euronext has publicly acknowledged, these are very much the exception.[4] New regulated markets, established specifically to increase competition and provide investors with choice, have made little impact. Furthermore, it should not be forgotten that sources of potential inter-exchange competition are being reduced by merger and acquisition.

This present and future reality is reflected in the worked example of a central order book in Appendix 1 of the Euronext paper. For even this grossly oversimplified market model can only work if all orders in a specific security at a moment in time are brought together in *one* order book for potential interaction. This is the well-known argument for a single or central limit order book or CLOB. That is, for any security there should be only one marketplace provided by a single exchange. This is a monopolistic view of an efficient market. It has been debated in the academic literature for many years but its manifold disadvantages have prevented its implementation in any jurisdiction in which the capital market is an important engine of economic growth and prosperity.

Not least among the problems of a CLOB are issues of ownership, governance, pricing, location etc. Could it be operated by a shareholder-owned ‘for profit’ entity or should it be required to set up as a mutual organisation owned by users ? At the very least it would require oversight by a regulatory authority with extensive resources and powers to control prices to ensure that it did not abuse its monopoly position. As Deutsche Börse has recently warned[5], monopolies are not innovators and are reluctant to keep improving operational efficiency.

It is not our position that a CLOB may or may not, in time, become the preferred solution of users. Rather we maintain that market participants: investors, issuers, intermediaries and regulated markets should *together* make this determination. It may be that this will become appropriate for certain stocks and not for others according to the characteristics of the investment, investor interest and the strategies used. It may even come to pass that trading a security on two different platforms is the most efficient market for that security. Markets evolve through various inputs and competition.

We do observe however, that in a period when Europe is moving steadily to remove monopolies in other areas, such as telecoms, power, water etc., on public interest grounds, it would be strange if, also on public interest grounds, a monopoly provider of a securities trading system was to be imposed on Europe’s securities markets.

Even if such a monopoly were to be mandated, it could not be enforced, because investors and issuers, in Europe and globally, could not be compelled to use it. For the key feature of the modern global capital market, which would doom a European monopoly marketplace to failure, is the mobility of capital, an aspect of the modern world strongly endorsed by most governments (at least in the advanced economies) and by international organisations such as the World Bank and IMF.

Furthermore, if there ever was an opportunity to create a monopoly European marketplace that time has long gone, not least because over 150 of Europe’s largest companies are listed on the NYSE and over 120 on NASDAQ. Daily US trading

[4] Euronext spokesman at the Open Hearing on the ISD, Brussels, April 22, 2002
[5] ‘Cross-Border Equity Trading, Clearing and Settlement in Europe’, April, 2002, page 29

volumes in these EU companies can be significant. For example, on 13 May 2002 (taken at random) Nokia trading volume was 20,244,800 in Helsinki and 11,631,000 on the NYSE (i.e. 36% of daily trading volume was in the US); Unilever NV traded 2,311,300 in Amsterdam and 771,500 (25%) on the NYSE; Ericsson traded 81,431,000 in Stockholm and 14,201,500 (15%) on NASDAQ. Investors (particularly institutional and corporate investors) will trade globally on the basis of price and service.

The real risk to the quality of price formation in Europe and damage thereby to investor confidence is therefore not from Europe's banks choosing to execute customer order flow away from regulated markets, but institutional investors in Europe, the US and elsewhere, routing orders in European and international stocks increasingly to New York to benefit from the greater range of trading options available there at more competitive prices. The recent US regulatory changes, which no longer prohibit Alternative Trading Systems from trading most NYSE listed stocks, and the move to decimalisation (spreads have narrowed dramatically from 12.5 cents to as little as 1 cent), is intensifying competitive pressures from that source. If Europe's response is to attempt to impose a statutory monopoly on equity trading, disaster lies ahead.

It is important to recall that since the 1980s, Europe's capital markets have made enormous progress in becoming engines of growth and prosperity. Europe's regulated markets, in particular, have made great strides in the products and services they offer users, and the fairness and efficiency with which they operate their markets.

Twenty years ago Europe's capital markets were small, illiquid and parochial. Sheltered by national controls on capital movements, mandatory single capacity, fixed minimum commissions and in some cases statutory 'monopoles', exchanges were cosy gentleman's clubs. Prices were fixed once or twice a day in call auctions on the floor of the exchange.

Today, spurred on by the EU's efforts to remove barriers to cross border movement of goods, services and capital, the resulting ever increasing competition among financial services providers, and the availability and decreasing cost of technology and information, Europe's capital market is characterised by continuous markets, competitively negotiated commissions, and dual capacity (within an appropriate regulatory framework to protect retail investors) all of which serve to make it liquid, transparent and fair. This progress occurred largely due to competition and innovation. This progress also occurred in spite of the protectionist legislation imposed by a few Member States in order to protect their national exchanges. However, it became clear early on that the only way an exchange could survive was to modernise and compete. The positive result, at least to date, is that Europe's securities market is healthier, more efficient and cost effective as a result of competition than was ever believed possible during the days of national protectionism. In turn, trading volumes have grown quicker since deregulation and the introduction of competition than they ever did previously.

Properly incentivised by sensible, proportionate legislative and regulatory initiatives, Europe's securities market and its participants are poised to play their full part in making the EU the world's leading knowledge-based economy by the end of the decade. This opportunity must not be jeopardised by imposing anti-competitive measures which would reduce choice, cause a withdrawal of trading capital, damage market liquidity and drive securities market activity to other jurisdictions which recognise the merits of (properly regulated) diverse market structures to meet investor demands.

## A return to 'single capacity'

The Euronext paper couples its call for an end to diversity and competition in the provision of execution venues in Europe with a demand for nothing less than the return to single capacity in investment firms. [6] The argument was last put forward to protect entrenched interests in London at the time of Big Bang in 1986. The argument was rejected in 1986 and the London capital market has gone from strength to strength and attracted inward investment in Europe's capital markets on an unprecedented scale. It is true that in the sixteen years since Big Bang many traditional firms in London have disappeared because they failed in the competition to meet the changing needs of investors and issuers or to invest in the new markets which a more liberal environment encouraged. For Europe as for London, the goal should be a securities market in which those who earn their living from it, whether they are banks, brokers, investment banks or exchanges, should be under constant pressure to improve, to offer new products, better prices and information, to reduce costs and better manage risk. The goal should not be the preservation of particular institutions or market models, however venerable.

The flawed logic of the argument that regulated markets must be the sole execution venues for all securities necessitates the abolition of dual capacity, where investment firms operate as brokers and dealers. In practice however a ban would be unnecessary. There is only the most limited role in the Euronext model for market makers (who put their capital at risk to satisfy the needs of investors for immediacy of order execution). They are permitted to provide liquidity to an exchange's users, but only when other investors' orders are not adequate to secure an executed trade at a reasonable price. That function, to be a buyer when no-one else wants to buy, or a seller when no-one else wants to sell, is not one which would enable most market makers to make an adequate return on capital. (Such entities exist or existed as specialists (New York Stock Exchange), Kursmakler (Frankfurt) or Hoekmann (Amsterdam) but in order to attract such players, the exchanges had to bestow some form of monopoly privileges on them to provide liquidity in specified stocks.) Under the Euronext model, most market makers active in Europe today would remove capital from the secondary market, which would result in a very large decline in the liquidity of the market as a whole. The result would be that all investors would suffer from wider spreads and increased volatility in all execution venues including regulated markets. The response of investors would in turn be to demand higher risk premiums from issuers which would increase the cost of capital.

The most obvious, and demonstrable argument against the end of diversity in the provision of execution venues and a return to single capacity investment firms is the success of the securities markets in the USA and elsewhere to which multi-capacity investment banks have contributed so much, not least from the enhanced liquidity they have created from the capital they have committed to taking on risk on behalf of their clients in the secondary market. A Europe which is serious in its ambition to exceed the performance of US financial markets needs *more* not less multi-capacity investment firms overseen by more effective national regulators. To do that Europe needs a market infrastructure in which major liquidity providers, who are not themselves end investors, see a realistic prospect of making a satisfactory return on

[6] Page 11, para 3 'The internalisation of securities orders at large financial conglomerates is exactly where the line should be drawn if the interests of investors and issuers of securities are to be safeguarded.'

capital committed to price making. This is Europe's true 'historic opportunity'. Europe must not, by legislation, constrain the opportunities for investment firms to better meet the needs of investors and issuers in whatever ways they can devise, consistent with high standards of integrity and fair dealing reinforced by effective regulation.

## A 'one size fits all' marketplace

If the European capital market is to continue to flourish it is essential to recognise the enormous diversity of investors and their needs.

Although in itself an oversimplification it is possible to readily identify:

- Retail investors who buy and sell stocks directly through traditional brokers and increasingly through discount brokers and the internet. They may trade frequently or occasionally but typically in small amounts – in a few thousand Euros at a time or less.

- Retail investors who invest through collective products such as UCITS, life assurance and pension funds. Orders representing the interests of hundreds or thousands of retail investors are entered by institutions, typically in large size - in hundreds of thousands or, frequently, millions of Euros.

- Corporate and institutional investors who buy and sell large blocks of securities as part of ongoing patterns of changing corporate control – their orders are usually very large indeed, better typified perhaps as percentages of a company's shares – 10%, 20%, etc.

- Investors who are prepared to wait to get the price they want and others who need immediacy (and are prepared to pay for it).

- Investors who have simple buy or sell orders and others whose orders are more complex.

Each group seeks the most efficient market to meet its needs. No *one* market model has yet been devised which will treat *all* investors 'equally'. What all of us who serve investors are, or should be doing, is constantly striving to improve the services we offer investors, to ensure that the optimum balance is struck in satisfying, *as far as possible* their diverse needs. We in the industry accept that there are important public interests at stake here. Choices have to be made. But those choices must be properly informed. In the next sections we try to describe how markets really operate in the 21st century, and why the central limit order book proposed by Euronext by itself does not, and cannot, properly meet the needs of the majority of investors and issuers.

## Two typical transactions in today's equity market

### *Example 1. A fund manager, acting on behalf of retail investors, needs to sell a significant holding of shares, quickly*

A UCITS manager receives a large number of orders from retail investors to redeem units. Perhaps it is January and the Christmas credit card bills have arrived. According to local rules the fund is required to pay them in three days. The fund is fully invested and has insufficient cash at the bank. Shares must be sold today. The manager reviews the portfolio and decides to sell 100,000 shares of Porsche[7] (out of his total holding of 300,000 shares of the company). He checks the market and sees that the last trade on the exchange was at €495. He also sees from the Limit Order Book that there are buy orders at 493 for 1,000 shares, 485 for 2,500 shares, 480 for 2,500 shares, 470 for 1,000 and 465 for 3,000 - a total of 10,000 shares. He checks the average daily volume and sees that Porsche trades 50,000 shares a day. He needs to sell two days' volume in one day.

*What is the fund manager to do?*

Today he has a choice.

<u>1. He can call a market maker and ask for a bid for the 100,000 shares.</u>

Since the market maker earns his living buying and selling Porsche shares he knows which institutions have a current interest in buying the shares. He makes a few phone calls and establishes that there is a pension fund interested in buying 25,000 shares at 494, a UCITS fund manager who will pay 492 for 35,000 shares and a life assurance company with a buying interest at 490 for 40,000. So the sell order can be executed against three buy orders at a price no worse than €490.

But while the UCITS fund manager is authorised to buy 35,000 shares immediately, the pension fund and the life assurance company will only make a formal decision after their investment committees meet later in the day.

So the market maker decides to offer the seller a price of 490 for the 100,000 shares, which is accepted. He makes an immediate profit of €70,000 on the shares he sells to the UCITS fund manager but invests his own capital in buying the remaining 65,000 shares – €31,850,000. *The risk is his*. The other buyers may, or may not, decide to confirm their orders. Market conditions may change, other sellers of Porsche may enter orders into the market, poor economic statistics may be published etc, etc.

For the clients of the selling UCITS manager the final position is this. Clients redeeming units receive €490 per share and remaining clients now hold 200,000 shares, revalued at €490.

<u>2. He can use the exchange's Limit Order Book</u>

If he does, the maximum he can sell immediately is 10,000 shares.

Results:
His investors have to accept a price as bad as 465 (compared to the last trade at 495).
Those investors who did not redeem units will have the value of their holding in the remaining 200,000 shares of Porsche reduced by 6% (465 v 495).

*Problem - he has used all the outstanding buy limit orders on the book but still has 90,000 shares to sell by the end of the day.*

Other investors notice the sharp fall in Porsche's stock. They do one of two things:

[7] This is a realistic example. The largest institutional holder of Porsche owns 600,000 shares. Several institutions own around 300,000 shares. I00,000 shares is approximately two days volume (April/May 2002). The order sizes on the order book are as quoted or smaller.

- they also enter sell orders fearing bad news; or
- they enter orders to buy Porsche cheaply.

The UCITS fund manager now sees a Limit Order Book which shows sell orders at 465, and 460 and buy orders at 458 for 3,000 and 453 for 7,000.
He cannot wait. He has a contractual obligation to pay the investors who are redeeming units. So he sells another 10,000 shares. He has still completed only 20% of his order.

The exchange's last trade tape publishes the information that 7,000 shares of Porsche were sold at 453, compared with a price a few minutes previously of 495. The company now gets calls from investors worried about the selling of its stock. They want to know whether the company is about to announce bad news, which, of course, it is not.

The company may feel obliged to put out a statement to say that it knows of no reason for the decline in its share price – which is true but may encourage even more selling by the cynical.

The exchange may suspend trading in Porsche's shares. This will stop the decline but leave the UCITS fund manager with a problem. He still needs to raise the funds to pay his clients who want to redeem units. And he has to do it today. So he chooses another share in his portfolio and the process starts all over again.

In this case it is impossible to say what the final position will be except that clients redeeming units will receive a price substantially below the price in the market when their selling order was entered, and remaining clients will hold units worth substantially less at the end of the day than at the beginning.

*This cannot be considered 'best execution'.*

<u>Who benefits, who is disadvantaged?</u>

The redeeming investors and those that continue to hold units in the selling UCITS clearly benefit from their fund manager taking option 1 – getting a market maker to search the market for counterparties and taking on the execution risk of the balance of the order.

Porsche, and other long-term investors in its shares, also benefit from option 1 because the share price is less volatile over the course of the day, and, probably has a higher closing price which better reflects its fundamental value. Longer term, lower volatility is likely to translate into a lower risk premium being demanded by investors and therefore a lower cost of capital for Porsche.

But it might be argued that the large sell order, even though it reflected no fundamental news about Porsche, should have been allowed to push the market price lower to permit investors prepared to enter buy orders in the central market to benefit (option2). But this argument is flawed. Only a lucky few, or highly speculative investors, (so-called 'vultures') will benefit. The others lose.

It might also be argued that the order, if entered as a limit order into the order book, would have narrowed the spread to everyone's advantage. In fact the reverse is more probable. A limit order which is large in relation to existing orders, or the average daily volume, is likely to cause limit orders on the other side of the market to be cancelled and re-entered with worse prices as investors adopt a more cautious stance. The spread would widen.

<u>The problem with limit orders</u>

In the example above, the size of the sell order and the absence of buy orders in equivalent size and reasonable price means that the ‘best’ limit orders will have been filled and the investors who had entered them will find that the price had dropped well below their limits. So they will be suffering large losses. For example, having bought 1,000 shares at 493, the best buyer on the limit order book will immediately see the stock trade at 465, a loss of 5.7%. And there will be worse to come.

When a large order is executed against the limit orders on the other side of the book, *the only significant beneficiaries are those who, by luck, or whose business is to seek to benefit in the short term from such excessive volatility, enter orders which execute against the last few shares left in the large order.*

This is a well-known and much analysed problem with limit order books, sometimes known as the ‘free option’ effect and for which no effective solution has been found. Unless the investor who enters the limit order constantly monitors his order (and an institutional investor may have many such orders in the market simultaneously), he will buy shares too expensively or sell shares too cheaply when the market moves rapidly to a new equilibrium price. That might happen because a large market order is entered into the system (as in the example above) or unexpected news about the issuer causes a fundamental revaluation of its shares.

*For this reason, institutional investors are very reluctant to leave limit orders on an exchange’s central limit order book and consequently, in the above example, institutional investors would not have expressed their buying interest via firm limit orders left with the exchange.*

***Example 2. Retail investors, acting on their own account, seek to buy a stock promoted in the weekend Personal Investment section of a major newspaper***

On Sunday, many investors who manage their equity investments directly read an article by a respected journalist to the effect that Digital Communications plc, a (fictitious) relatively small but fully listed stock on the London Stock Exchange is, in his view, a market leader in its field and will shortly be announcing a range of new products to reinforce that lead. He considers that Friday’s close, at 61p, significantly undervalues the company which he expects to be trading at around 120p in twelve months’ time.

On Monday morning, before the market opens, 100 retail investors call their brokers to buy the stock. In total their orders amount to 400,000 shares whereas the recent daily trading volume in the stock has been 50,000 shares. Some orders are entered at the Friday close, others at prices up to 75p and some at the market. No retail investors enter sell orders. The orders are displayed on the pre-opening screen of the exchange’s limit order book.

Other investors read the same article. A trader who earns his living trading on a short-term speculative basis judges, correctly, that the article will have encouraged a large number of retail buyers. He watches the pre-opening quotation and, just before the market opens, enters a short sell order at 80. In accordance with the opening algorithm of the computerised order book, the market orders execute at 80, a premium of 31% over the previous day's close, and the trades are published. Some cautious buyers then decide to maintain their limit orders, others (more optimistic) increase theirs to 80 and are executed against the short sell order.

This flurry of activity attracts the attention of other short sellers and one or two institutional investors who are looking for a day such as this to sell positions on which they have been losing money for some time. They begin to hit the remaining limit orders. Brokers representing some of the investors who entered those limit orders find that they cannot contact their clients and, with no instructions to cancel the limit orders, watch as the limits are hit and the stock continues to go down. By the end of the day Digital Communications plc is trading, again, at 61p.

*Were those investors whose buy orders were executed, well served by the limit order book of the exchange? We think not.*

There are, admittedly, no easy solutions to situations when a reasonable balance as to price and volume does not exist in the market for the shares of a particular company or in the market as a whole. These situations are far from uncommon.

However, when brokers and dealers are permitted to internalise order flow, an additional factor, the relationship between the firm and its clients, can have a significant effect on the outcome, to the clients' benefit.

In the circumstances described above, a broker with several retail buy orders might go to an institution he knows to be a seller and, because he can offer the institution a bid for a single trade in a reasonable number of shares, negotiate a price for his buyers which, while not as good as Friday's close, is significantly more advantageous than that offered by sellers in the market who owe no duty to the buyers and seek merely to exploit their enthusiasm.

Or a dealer might have a long position on his book which he is prepared to sell at a modest profit to his clients but not to others.

In these difficult circumstances the key is not to prohibit transactions based on the relationship between the investment firm and its clients but to encourage them, subject to appropriate regulation. It is true that not all investors are treated 'equally' in this scenario since that depends on the quality of the brokers and dealers concerned. But, unlike the scenario where reliance is exclusively on the exchange and its limit order book, not every investor is treated badly.

## The case for internalisation of orders

Euronext argues that banks internalise order flow solely to avoid exchange fees and to keep, for themselves, the bid/offer spread. [8] This is untrue. In striving to constantly improve the service they provide their clients, banks operating in a competitive environment must be responsive to the fact that exchanges' limit order books do not adequately accommodate the many and changing needs of investors, whereas the current diversity offered by banks, brokers, dealers and exchanges has a better record of so doing.

In addition to the examples above, there are many others:

[8] Page 12, para 2

*Modern portfolio management* has developed many sophisticated trading techniques which fund managers use to increase returns to their clients. Most of them cannot be carried out via a central limit order book. These include:

- *Programme trades*: where a fund manager seeks to sell a number of large holdings in various stocks as a package at one net price. He may have decided to get out of a particular market sector for example. Dealers are asked to bid for the package and the winner assumes the risk of selling the stocks on. He may use the limit order books of exchanges or negotiate directly with other institutional investors.

- *Market neutral trades:* where a fund manager seeks to simultaneously buy a stock he considers cheap and sell (or sell short) a stock he considers expensive.

- *Buy/write trades:* where the investor seeks simultaneously to buy a stock and write a call option against it to increase his income in holding the stock.

*Very large block trades* often involving holdings acquired as a result of merger and acquisition activity by corporations, would have to be carried out in other jurisdictions if a Central Limit Order Book was the only legal mechanism in Europe for order execution. The costs of attempting to execute the trades would be too high, if they could be carried out at all, and the damage to the price of the shares from piecemeal execution would be immense.

Recent examples include:

The sale of 9.4% of the Dutch telecoms company KPN for €1.2 billion by the US telecoms company Bell South. The 237 million shares represented 17 days' average trading in KPN. The transaction was at a discount of only 0.6% to the closing price.

The sale of 100 million shares of GlaxoSmithKline, a UK drug company, for €2.9 billion, at a discount of 1.9% to the previous night's close.

The sale of€1.1 billion of shares in Vivendi Environement, a French water utility, for a discount of 5.8%.

If an exchange-operated central limit order book was to be the only legal means of executing orders in Europe, these trades, and others that may be developed in coming years, will have to be carried out in other jurisdictions.

The quality of price formation

Euronext argues that internalisation damages the quality of price formation in the central market, that spreads widen, pre-trade transparency declines, and investors receive worse prices for their orders. [9]

The argument that pre-trade transparency is damaged overstates what pre-trade transparency reveals. Pre-trade transparency does not provide a full picture of the totality of buy and sell interests. Limit orders merely give some indication of the orders which some investors are prepared to (i) make public and (ii) have executed immediately and regardless of market conditions. As Example 1 above makes clear, the risks inherent in using a Limit Order Book mean that it contains a small sub-set of the true level of buying and selling interest at any particular price.

[9] Page 4 bullet 2; page 14 para 2, Appendix 1 etc

The claim that in a central market there is 'full' transparency[10] is a myth. There never will be full equality of information.   An individual's order in 100 shares will be exposed to the market. An institutional investor's order in 500,000 shares may be shown in its entirety but in almost all cases – quite reasonably - the market will be shown only that part of it which the institution and its broker believes can be exposed with least risk of moving the market against the order (or the institution's remaining position in that stock, if any)  – perhaps 5000, 10,000 or 100,000 shares at a time but not the full order.

Furthermore, in order to try to reduce these risks, many exchanges have developed facilities, often called 'iceberg' facilities, whereby an investor with a large order can expose to the market only a small proportion of his total order. So, for example, a published bid for 1,000 shares may in reality be part of an order for 100,000 shares.

In terms of pre-trade transparency and the information available to investors there is little to choose between a bank handling these orders 'in house' and entering them on an exchange's limit order book. Indeed, partial disclosure via the exchange may be, in effect, misleading.

The argument that spreads widen when banks execute orders against their own books or against other client orders ignores an elementary yet basic market mechanism for keeping prices in multiple execution venues in line with each other and at narrow spreads. That mechanism, employed by generations of traders, is 'arbitrage', whereby dealers monitor markets for price disparities and execute matching trades in two markets when prices move out of line (eg buying in one market and selling in another).  Arbitrage-oriented dealers have access to bank dealing desks and ATSs as well as regulated markets' order books and thereby ensure that prices in all three types of execution venue diverge slightly, if at all.

<u>Other benefits of banks executing client orders against their own book or with other clients</u>

Euronext's case also ignores the issue of whether an exchange may be inefficient and its fees too high. If it is, investors whose orders are executed on the exchange will pay unreasonably high commissions.  Competition by banks for investor order flow has ensured that regulated markets have striven assiduously to reduce their own costs. It is important to maintain that pressure.  Furthermore, since regulated markets generally charge a fee per transaction, a bank can save money for investors by transacting several trades internally for clients and executing just one trade (representing the net buying and selling of its clients) on the exchange.

It may also be the case that the exchange may not have the technical capacity to handle the level of business the banks want to transact, resulting in delays and poor quality prices.

Competition and transparent fee structures will ensure that banks share the savings they generate with their customers through lower commissions or prices which improve upon the best bid or offer on the regulated market.

There may also be market specific reasons why client orders cannot be executed via an exchange's limit order book. For example, in the UK many retail investors

[10] Page 9 para 1

cannot/will not trade on standard stock exchange terms (dematerialised stock on T+3) and so their orders cannot be executed via the limit order book, SETS.

More generally, many exchanges now require trades executed via their limit order books to be guaranteed by a central counterparty (a specialised bank or similar entity). Many central counterparties require users to have significantly more capital than the regulatory minimums so that many small brokers cannot join. If they wish to use the limit order book they have to employ the services of a larger broker which, for a fee, passes the small broker's trade through its account at the central counterparty. This increases the small broker's costs and reduces his competitiveness in the market, to the benefit of an exchange's larger and more influential members. Indeed, as commercial entities, exchanges will favour those members (and issuers) which generate the most trading and other fees since this is how exchanges earn their livings and create shareholder value.

It is vitally important that Europe preserves the ability of small brokers (who, as a group, are often a key source of new and innovative ways to meet investor needs), to have access to alternative execution venues. Far from aiming to create 'elitist' pools of liquidity as Euronext appears to believe, most large investment banks and brokers are eager to have smaller banks and brokers as clients and compete to create specialised products and services for them and their clients.

## Regulation works

*Regulation of banks and brokers which internalise order flow is a proven cost-effective alternative to mandatory order routing to a regulated market.*

Euronext argues that internalisation of order flow creates numerous problems which result in inefficient and inequitable execution, which ultimately damages investor confidence in the market. It builds on that hypothesis with the claim that regulation cannot remedy this problem, or if it can, only at excessive cost.[11]

These claims are both contradictory and untrue. In those jurisdictions which have, for many years, imposed upon investment firms conduct of business rules which govern the way a firm deals with its clients, issues such as the equality of treatment of client orders, strict implementation of time priority rules, best execution against clear benchmarks (where they exist), strict implementation of allocation rules (where a block trade is divided between several investors) and so on are addressed through tried and tested mechanisms to ensure fairness between clients of investment firms and between firms and their clients. Core EU-wide standards on each of these points will be implemented by the members of CESR[12].

Good regulation is not cheap but neither is the cost of verification excessive. Today, thanks to IT developments, investment firms which automate the process of order routing and execution not only provide clients with finely differentiated pricing, but also generate accurate, highly time specific audit trails which promote cost-efficient compliance monitoring. The cross-subsidy argument is also flawed. A well-managed regulator will ensure that the costs of regulation fall on those firms which generate them.

[11] Page 12 para 4
[12] 'A European Regime of Investor Protection – the Harmonisation of Conduct of Business Rules' (Committee of European Securities Regulators CESR/01-014d)

There also appears to be a misunderstanding about the objectives of firms which execute client orders against their own proprietary positions. Such a firm will, naturally, seek to trade with clients at prices which enable it, over the longer term, to make a reasonable return on its capital. However, a firm which systematically sought to disadvantage its clients by quoting poor prices would very soon find that it had no clients. Competition for clients in financial markets is fierce. Investment firms which act in dual capacity have, for many years, operated with organisational structures and conduct of business requirements which seek to minimise this danger. Typically, client relationships are managed by brokers who are incentivised by the number of clients they attract and retain, funds under management and so on. Responsibility for the trading book is in the hands of a trader who, naturally, is incentivised primarily by the return he achieves, although many firms whose income derives primarily from client business poll their clients on a regular basis to ensure that they are satisfied with the quality of execution provided. Regulation designed to ensure that such conflicts are properly managed recognises and reinforces these measures.

## Conclusion

A central limit order book is only fair and efficient if all investors who wish to transact in that investment have orders of similar size, if numbers of shares on each side of the order book are approximately equal, and closely grouped, price-wise, around the mid-price between the best bid and best offer, and if investors have no need for immediacy.

No such market exists. Instead, there is a diversity of investors with a diversity of needs. There are large orders and small orders; investors who need immediacy and others who are prepared to wait; simple buy or sell orders and multiple orders which are part of complex trading strategies. There are times and situations when end investors provide sufficient liquidity to satisfy them all; there are others when market-maker-provided liquidity is essential if volatility, or the inability to get transactions executed at a reasonable price, is not to cause a large market impact . A successful market place accommodates this diversity by providing a variety of execution mechanisms and venues. It does not dictate to investors how they must trade. It provides an environment in which those who provide services to investors, be they exchanges, banks, brokers or dealers, do so competitively, and with the minimum necessary regulatory intervention.

Giving exchanges a statutory monopoly and mandating the routing of all orders to a Central Limit Order Book, and allowing exchanges to dictate how their natural competitors are to compete with them, is not such a market place. If Europe adopts such a proposal, liquidity in its securities markets will be severely damaged, the overwhelming majority of investors will receive worse prices, and the cost of capital for issuers will undoubtedly rise. For Europe’s aspirations in the global economy, this would be fatal.