ABI Associazione Bancaria Italiana

Response to CESR's consultation on the impact of MiFID on secondary markets' functioning

12 December 2008

POSITION PAPER

Introduction

The Italian Banking Association is pleased to have the opportunity to participate in the consultation launched by CESR on the impact of MiFID on secondary stock markets' functioning.

ABI considers this subject matter a key issue, given that great expectations had been raised with regard to MiFID's impact on secondary markets. However, we believe it's still too early to fully appreciate any changes brought about by the new regulations, which have been implemented only recently. Even if in other European countries innovative trends have started to arise with regard to markets, the situation differs greatly across the EU.

We therefore recommend authorities wait until the full range of effects of the new regulations have occurred before drawing any final conclusions with regard to the directive's impact on the secondary market.

We deem it necessary to specify that our positions expressed below only concern the Italian stock market, unless otherwise indicated, and must be considered preliminary considerations; a more in-depth evaluation may only be carried out in the future, when presumably the full range of MiFID's effects on the market, on financial intermediaries and, most of all, on investors will become evident.

Observations on the consultation paper

1. Benefits and disadvantages

First of all, it must be noted that the MiFID directive, although implemented a year ago, has not yet delivered its expected benefits in terms of competition between trading venues.

Specifically, in Italy this is probably due to the fact that the previous regulatory regime, which set out that shares had to be traded on regulated markets, made it difficult for new trading venues to emerge, even after the prior regime was abolished.

On the one hand, the fact that shares have been mainly traded on regulated markets for a long time allowed the Italian market to grow and become consolidated in the past ten years; on the other hand, it influenced the trading service sector's structure, which formed around the regulated market. Therefore, Italy may require a longer implementation period, with respect to other countries where the new regulations did not bring about any significant change.

Moreover, we must not underestimate the effects that the global crisis battering financial markets (especially due to a significant drop in trading volumes) has presumably produced in terms of slowing down, if not preventing, the migration to trading on venues other than regulated stock markets.

In general, we believe that a limited interoperability and, therefore, a low level of competition between clearing and settlement infrastructures and, specifically, the failure to create proper connections between Central Securities Depositaries (CSD) and Central Counterparties (CCP), as set out in art. 34 of the MiFID Directive, hinders competition between trading venues.

Despite the fact that competition in Italy is still not sufficient, potential market fragmentation risks entail an increase in costs in the short term, owing to financial intermediaries' need to monitor a higher number of trading venues for purposes related to the definition of their execution policies.

Lastly, the fact that the Directive fails to set out a transparency regime with regard to the bond market that is similar to that set out with regard to the stock market, may represent a disadvantage in terms of *level playing field* (see below).

In general, we agree that the Directive has brought about innovation to secondary capital markets, although not yet in a uniform manner, which is also proven by the fact that MTFs for trading shares have emerged in certain EU countries. However, we will need to verify, in the future, whether such benefits will be extended geographically and whether the new regulations actually enhance increased capital market integration across the EU.

In this environment, we expect that, for what concerns investors and savers, benefits will arise from the fact that the requirement to trade shares on regulated markets was abolished as well as from an increase in competition between trading venues; such expected benefits are the following:

- a decrease in spreads, due to the fact that financial instruments are listed on different trading venues, whose microstructure may differ and which may function differently (order driven – quote driven – mixed markets);

- a decrease in costs incurred to access trading venues (for example, some trading venues offer rebates in case proposals to trade may not be executed immediately and which may be applied by other market players);

- adopting automated procedures (smart order router) to find the best possible price at any given moment.

2. Trading costs

One of the main effects of the directive's failure to deliver its expected benefits with regard to the stock market in Italy is the fact that costs have not decreased since the directive was implemented. As mentioned above, in Italy competition between trading venues (both in terms of number of alternative trading venues and in terms of diversification of shares traded) is still not significant and the majority of financial instruments are still traded on the main market.

A significant decrease in trading costs is expected (and desired) in the future, when European MTFs on which Italian shares are traded will be fully operational. This decrease in costs, however, may be partly offset by investments made (in IT and resources) and costs incurred by financial intermediaries to access such new alternative trading venues.

3. Potential fragmentation

As previously mentioned more than once, there is no sign of trading fragmentation in Italy due to the absence of significant competition between trading venues. Although some shares of Italian firms are traded on alternative facilities across the EU, trading is still not significant. Also in this case we must wait until new trading venues emerge and the number of alternative trading venues in Italy increases.

For what concerns pre- and post-trade transparency's potential effects in terms of mitigating fragmentation, there are no data available to evaluate this issue. A more in-depth analysis of the issue will be provided in the next paragraph.

4. Transparency

There has been no significant change in transparency with regard to trading of shares; this is due to the fact that the previous regime on trading of Italian shares, which used to be in force prior to the implementation of MiFID, was substantially in line with the current regime (see below) and also to the fact that, as mentioned above, the majority of shares are still traded on the regulated market.

Nonetheless, our main concern regards the fact that, should there be liquidity fragmentation in the future between alternative trading venues and over-the-counter markets, only a consolidated transparency will allow us to overcome the negative effects of such fragmentation.

For what concerns *dark pools of liquidity*, we believe they play a key role (the "block market" used to have the same function in Italy), since they allow investors to purchase/sell significant blocks of shares without negatively affecting prices (market impact). From this point of view, a limited pre-trade transparency is essential to avoid such impact. However, it must be noted that, with regard to post-trade transparency, the new regime under MiFID sets out that large trades shall be made public only after a certain period of time has elapsed; on the matter, we should take into account of the fact that in Italy, under the previous transparency regime, the market had to be informed of any block trades within 10 minutes after their execution.

5. Data

The availability of information is undoubtedly a key element for investors as well as for financial intermediaries, which need to be provided with information, even in real time, to handle their customers' orders in accordance with the best execution principle as well as to monitor those trading venues that are still not included in their execution policy, in view of reviewing the latter.

The quality of the information available is also important: financial intermediaries need accurate and reliable data concerning trades in order to perform the above-mentioned activities.

As mentioned above, we fear that, when competition between trading venues starts to increase, information may also become fragmented and, therefore, costs may potentially increase.

Our concerns regard the fact that trading venues, which used to provide their intermediaries with pre- and post-trade information (trading book and *ticker*) as part of the participation fees, may modify their offer and impose an extra fee exclusively regarding the market information note.

From this point of view, we suggest that authorities play a more active role, also at a national level, to make data on listed shares traded available, data received for purposes pertaining to *transaction reporting* (also as aggregate data). This would certainly bring significant benefits to the market; moreover, these benefits may even exceed the costs currently incurred by intermediaries for purposes pertaining to reporting.

6. General remarks

We believe it's still too early to make final remarks on whether MiIFID has delivered its expected results with regard to the secondary stock market. We believe that over the past year, since MiFID was implemented, intermediaries have basically invested significant resources for its implementation and have not yet enjoyed any real benefits.

Just to provide you with an idea on the amounts invested, it must be noted that start-up costs incurred by Italian banks with regard to the implementation of MiFID are estimated at approximately 300 million euros in addition to 60 million of on-going costs on an annual basis (the above-mentioned are preliminary estimates, therefore, these amounts are likely to be underestimated).

According to an analysis conducted on a sample of banks, those activities that are mainly linked to markets absorb more resources, due to the high level of procedures and technology required (best execution, transaction reporting, pre- and post-trade transparency).