

ISD II DIRECTIVE DEBATE ABOUT THE TRADING VENUE DIVERSITY:
THE TREE AND THE FOREST

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INTRODUCTION

This paper presents the findings and preliminary conclusions of a study carried by GEF between March and May 2003 on the debate about the trading venue diversity which was triggered by the proposed update to the Investment Services Directive. The study covered the following topics:

- The current status of ISD debate and its dynamics
- The internalisation debate and the underlying issues of the evolution of the economic structure and the competitive position of the European stock exchanges
- The role of information technology in financial markets transformations
- A review of the ISD II architecture of its major innovation: the MTF concept,
- Preliminary recommendations: avoiding a middle-of-the road trap and eluding the “rear-view mirror” risk.

The study was based on:

- An extensive analysis of various documents, elaborated either by the Commission or by concerned parties (List of documents attached as Annex 1)
- Informal contacts and meetings with interested parties.
- Comments on the first draft of the study.

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EXECUTIVE SUMMARY

1. Investment Services Directive (ISD) is the keystone of the European Union's Financial Service Action Plan, aiming to mold a unified securities market among EU member countries. It defines the regulatory framework for interactions between market structures, intermediaries, issuers and investors in securities. The proposed Investment Services Directive (ISD II) updates the ISD I, promulgated at the European level in 1993 and implemented by member countries between 1993 and 1996. The ISD II was prepared under the Lamfalussy process, which seeks to streamline the law and rule making procedures, while making these more open and participatory. The ISD II proposal is intended as a level I framework legislation.
2. While various parties apparently all agreed on the need for the ISD update, the development of the proposal has been quite disputatious. Discussion and disagreements focused on a common theme of the **trading venues diversity**. All participants in the debate recognise that the European trading infrastructure has become more diversified and open in the last ten years. At the same time, they disagree strongly about the extent, the duration and the impact of this diversity. Within the diversity theme, the debate has focused on the topic of "**internalisation.**" Yet, the internalisation question, although important, does not fully exhaust the trading venues diversity theme. The internalisation tree should not hide the trading venue diversity forest. What is really at stake in the ISD II debate is **the role of the stock exchanges in the emerging landscape of securities markets**.
3. Over the last decade, the economic structure of European stock exchanges was profoundly altered. The stock exchanges have evolved from a co-operative to a demutualised model. All major European exchanges are now listed and have at their disposal considerable capital resources. In short, exchanges have become full-fledged financial services enterprises. This transformation has triggered a growing rivalry between exchanges and their principal users and erstwhile owners. Some financial institutions begin to see their relationship with exchanges as a zero-sum game, where the revenue and profitability gains of the latter come at the expense of the former.
4. Under ISD I, the exchanges were given what some considered a privileged status, in recognition of their role as central marketplaces and price discovery mechanisms. Thus, ISD I allowed the selective adoption of the concentration rule, which forced trade orders to be channelled to regulated markets. The core ISD II assumption is that the concentration rule is no longer justified and thus ISD II proposes to proscribe it. It is this assumption and the ensuing proposal that are being challenged through the internalisation debate, which is in fact a new disguise for a protracted argument about the respective merits of securities markets' concentration and fragmentation. The debate and the underlying argument remain inconclusive. One of the main reasons for this is a **definitional ambiguity**. Internalisation is not a homogenous, monolithic concept. It is a far-stretching notion covering markedly different operations. Most commentators refer to it as an activity of large broker-dealers, "which may execute client orders internally against proprietary trading positions" Internalisation is also sometimes defined as "in-house order-matching." Occasionally, internalisation is meant to cover all forms of off-exchange trading. These definitions do not form a coherent whole. The debate on internalisation mixes up three distinct questions: the merits of market-making, the rationale for alternative trading systems, and the order flow and transaction management strategies of large

financial institutions. These questions are interrelated by common threads of market quality and market transaction costs, but they need to be addressed explicitly and analytically.

5. Market quality and market liquidity concepts have been transformed by the increasing diversity and complexity of financial markets. Extraordinary quantitative growth over the last thirty years made the markets ubiquitous, and begot their qualitative transformations. Financial markets spread across geographical space and national boundaries. To accommodate a greater variety of issuers and investors, the range of listed and traded instruments was greatly expanded.

Underpinning the financial markets transformation is the **massive use of information technology**. Technology makes possible the scalability of transaction volume and the global market reach. It provides the required design and development tools for new financial instruments and the infrastructure to transact them. It allows the development of new trading models and structures. All markets are becoming electronic. Yet, far from making the markets uniform, information technology accommodates and stimulates variety and diversity.

Technology impacts all aspects of securities markets, not only the trading but also the post-trade processing and the information dissemination. Moreover, information technology has deeply affected the articulation between pre-trade, trade and post-trade segments of the securities value chain. Initially, it facilitated consolidation and concentration of pre and post-trade activities. Over time however, users sought more flexible and decentralised arrangements. Traditional distinctions and trade-offs between centralised and distributed systems basically lost their pertinence. In the new environment, it does not really matter whether trading and information systems are centralised or distributed, as long as they are interconnected and their underlying data standardised

6. The evolution of the markets is not a clear-cut trajectory but is marked by crosscurrents: consolidation and proliferation coexist (not always peacefully). On the one hand, financial markets are subject to a strong concentration pull. "Liquidity begets liquidity," and, as a result, liquidity pools tend to become larger.

On the other hand, successive waves of innovation led to a proliferation of new markets and to a more intense competition within existing markets. During the 1980s, an entire family of financial derivatives markets was born. In the 1990s, the internet sparked-off a new generation of markets. While the majority of internet-based market initiatives have failed, enough remain to constitute a significant factor in the evolution of markets.

The financial markets structure will remain unstable and dynamic, its perimeter and competitive dynamics incessantly evolving. The major challenge to the European financial markets stakeholders is not the consolidation but the **interconnection**: the creation of common rules, standards and infrastructure links across various markets.

7. In spite of significant differences between the US and European contexts, the evolution of the regulatory framework for the US securities markets provides a relevant reference for the European efforts. The main US regulator, the Security and Exchange Commission (SEC) has long recognised both the benefits of intermarket competition and the crucial role of technology in market evolution. In its oversight of the deployment of technology, SEC aimed to preserve a fragile equilibrium between competition and co-operation. It thus adopted a flexible attitude toward order routing

by intermediaries: it allowed internalisation, payment for order flow and upstairs trading for block transactions.

The SEC was quick to appreciate the potential of the internet as a vector of trading system innovation and a spur of greater competition. In April 1999, it adopted the [Regulation ATS](#) (Alternative Trading Systems), creating an intermediate market participant category, positioned between the broker-dealers and the full-fledged exchanges.

8. The need for introduction of a new category of investment services has been extensively discussed during the elaboration of ISD II. After extensive internal and external discussions, the ISD II draft proposed a **new category**. Under the ISD II, there would be three categories of investment services: regulated markets, investment firms, and Multilateral Trading Facilities (MTF), a new core service.
9. Probably the most significant feature of the proposed regulatory rules and requirements for **regulated markets** is what they do not do. The new framework does not impose major constraints on their scope of activities and services. The proposal does not preclude vertical integration between trade and post-trade activities. It explicitly authorises regulated market to offer MTF. It would thus appear that the ISD II proposal seeks to bring the regulated markets within the common purview of financial regulation.
10. **Off-exchange trades & internalisation by investment firms** is the most controversial part of the ISD II framework. Its authors attempt to trace a “third way” between those who refuse to legitimise what they consider as fundamentally unsound habits and those who believe that no undue restrictions should be imposed on the well-established market practices. Their approach is to emphasise measures to protect investors. Thus the directive proposal imposes trade disclosure requirements. While post-trade reporting is generally accepted by market participants, pre-trade transparency (Article 25) is the epicenter of the controversy.
11. **MTF is a real innovation of the ISD II proposal**. The goal here is not to codify an established business practice but promote a new competitive dynamics. Most analysts tend to use the terms of ATS and MTF interchangeably. Nevertheless, there are significant distinctions in their meaning. Alternative Trading Systems is a B2C concept which refers to systems which primarily deal in equities, compete with exchanges for order flow and focus on active retail investors. Multilateral Trading Facilities (MTF) originate in the world of derivatives. Their main focus is the over-the-counter market for financial professionals. It is a B2B concept. MTF introduces two new dimensions in the ISD: trading venues for new instruments, and competition between the exchanges and the over-the-counter (OTC) markets. These markets are considerably larger than the regulated markets for equities and continue to grow rapidly. While their primary purpose is the risk management and transfer, regulators are concerned about the lack of oversight and the potential for systemic risk and are looking for ways and means of increasing the transparency and the oversight of OTC transactions.
12. MTF regulatory regime is close to that of regulated markets, with one critical difference however: MTF can provide trading support to tailor-made instruments and transactions. It can also trade listed instruments and compete directly with established exchanges.
Entry barriers and operating burden for MTF are higher than for investment firms. Furthermore, MTF operator cannot intercede to facilitate trades or participate in

transactions with MTF users. Therefore, the most likely MTF operators would be the existing ATS and the exchanges. For ATS operators, MTF would offer a more robust and predictable regulatory set-up. For the exchanges, it provides an opportunity to leverage their skills and resources in a more flexible context. ATS and exchanges are already locked into a competitive battle for new opportunities in financial markets. MTF section of the ISD II aims to codify the rules of this battle.

13. The ISD II debate highlights the risks of a **middle-of-the road trap**. As it seeks to accommodate deeply conflicting interests, ISD II proposal is attacked from all sides. For some, it is too prescriptive and dirigiste, for others, too flexible and laissez-faire. As the proposal moves toward its legislative enactment, the level of contentiousness is bound to further intensify. Recent proposals to simplify and to shorten the draft, in the spirit of the Level 1 framework legislation, are unlikely to be retained. Nevertheless, for the long-term success of Lamfalussy approach it is essential to clarify the meaning and the usage of Level 1 legislation.
In the short-run, it could be useful to expand the definition section of the law (Article 3) to include “internalisation” and sharpen the distinction between internalisation, MTF and Regulated Markets.
14. As ISD II progresses toward its eventual enactment, it is important not to lose sight of underlying policy issues and to pursue the substantive debate among market “stakeholders.” However, to make such a debate more productive and to reduce the level of conceptual confusion and quasi-religious polarisation that have marked recent discussions, following assumptions need to be recognised:
 - The European market evolution is still on-going. Major changes in product offerings, asset class coverage, participant perimeter and competitive structure are still ahead of us.
 - ISD II legislation should not impede the fluidity of this evolution and should avoid the “rear-view mirror” risk. It should have a built-in adjustment ability, particularly at the implementation and oversight levels.
 - Information technology plays a critical role in market evolution. It has rendered obsolete the foundation of many regulatory and institutional constructs. The core notions of transparency, liquidity, centralisation and fragmentation should be revisited and reassessed in order to better understand their evolution and its relevance to the pertinence of the regulatory framework.
 - The technological dimension has not been given proper and explicit consideration in the process leading to the elaboration of the proposal. The current rule making procedures do not provide any fora to systematically analyse interactions between information technology and financial markets. This gap entails a non-negligible risk that the policy-making process may lead to unrealistic recommendations and/or suboptimal results.
 - Systematic efforts should be made by ISD II “stakeholders” to better understand the impact of information technology on financial markets and to introduce technological dimension in policy considerations. Specific industry and inter-industry fora should be set up to research and discuss this impact.

ISD II DYNAMICS AND CURRENT STATUS

Background

The proposed Investment Services Directive (ISD II) is the keystone of the Financial Services Action Plan (FASP), adopted by the European Commission in 1999, and whose overall aim is to achieve a single European financial market by 2005.¹ ISD II updates the existing Investment Services Directive (ISD I), promulgated at the European level in 1993 and implemented by the EU member countries between 1993 and 1996. ISD I introduced the single passport concept into investment services. More importantly, it formalised a regulatory framework where the stock exchanges (regulated markets) played the pre-eminent role in the market structure. It provided a rationale for the enactment by several countries on the European continent of the so-called “concentration rule”, which created a legal obligation of a preferential routing of order flows to official exchanges.

While the ISD I played an essential role in the shaping of the legal framework for European financial markets in the 1990s, it was broadly felt by regulators and market participants alike that since the adoption of a single currency for a majority of EU countries, there was a need for a substantive update of the legislation.

The ISD II preparation was one of the first examples of the Lamfalussy process, which is intended to streamline the law and rule making procedures, while making these more open and participatory.² Under the Lamfalussy process, European financial services legislation and regulation-making is articulated through three levels:

- **Level 1:** European level framework legislation, elaborated through close interactions among the European Commission, the Council of Ministers and the European Parliament
- **Level 2:** European level implementation guidelines, with CESR (Committee of European Securities Regulators) playing a pivotal role.
- **Level 3:** National level legislation and regulations

The ISD II proposal under discussion is intended as a level I framework legislation. In the aftermath of the adoption of FASP, the idea of the ISD update was broadly accepted by all European securities markets “stakeholders”: financial institutions, stock exchanges, issuers and investors and policy analysts. The formal update process of ISD was launched in the late 2000. It went through extensive open consultations, including two rounds of public hearings and calls for written comments.

The current proposal was published by the Commission in November 2002.³ It is an impressive and weighty document, containing 67 articles and more than 100 pages long.

The key objectives of the ISD II are:

- To support the emergence of the Single Financial Market in the European Union
- To heighten investor confidence and customer protection
- To promote the emergence of an efficient, transparent and integrated financial trading infrastructure
- To strengthen enforcement and supervisory cooperation.

Its main guiding principles are:

- Home country authorisation and supervision
- Sufficient harmonisation to allow mutual recognition
- Open competition in the provision of services and marketplace functions
- Establish proportionate regulatory measures.

“Rear-mirror” risk

Although the broad idea of ISD II was consensual, its specific content was contentious from the beginning. Every step of its elaboration was accompanied by intensive public and private lobbying by various stakeholders. The consultation process highlighted not only the diversity of opinions but also deep conceptual and policy divergences on the overall vision of the evolution of European financial markets. The current proposal is a precarious compromise between various, often radically conflicting, views and interests. The result does not really satisfy anybody, either the Commission, or the financial intermediaries from EU countries, exchanges, regulatory authorities or academics, looking for conceptual coherence and crispness. More importantly, it is clearly a “work in progress,” whose final shape and structure are not yet fully formed.

It could be argued that this is an unavoidable outcome of a multifaceted process with high financial and political stakes. Nevertheless, it is not clear that the proposal is fully consistent with the Lamfalussy process’ intent of streamlining and clarification. The ISD II document is longer and more complex than the ISD I directive. For a Level I framework legislation, the text is highly detailed and often procedural. In order to avoid misunderstandings and to ensure full compliance, its architecture is sometimes redundant and confused: for instance, the respective roles of statutory measures and of code of business conduct rules in the enforcement of requirements of transparency and best execution appear to lack clarity.⁴

Furthermore, there is a real risk that the on-going process of back and forth discussions between the Commission, the Council of Ministers and the European Parliament leads to an even more complex and detailed legislation. Suggestions have been made to simplify the text and focus legislation on broad principles,⁵ but it is not sure that in the context of intense horse-trading between various parties, they will be listened to.

The complexity of underlying issues and the intensity of the debate lead many observers to believe that the official timetable, with early September as a deadline for the political agreement at the Council level, may be overly optimistic.

Thus, the elaboration of ISD II is marked by a considerable degree of uncertainty concerning both the final content of the official proposal and the timing of its progress through the enactment process.

This creates a “rear mirror risk” that the final proposal lags behind a rapidly changing environment of financial markets. Its effective role would then be to codify a de facto situation rather than to shape its evolution. This appears to have been the case for the ISD I, which was promulgated some eight years after the start of the deregulation of the London market (“Big Bang”) and six years after that of the Paris market.

THE CORE ISSUE: THE CHANGING ROLE OF STOCK EXCHANGES

Beyond the uncertainty of the final legislative outcome and the “sound and fury” of ISD II debates, it is possible to identify a common and persistent theme: the **trading venues diversity**. All participants in the debates recognise that the European trading infrastructure has become more diversified and open. ISD II is intended to establish a regulatory framework for this diversity and openness. At the same time, the participants disagree strongly about the extent, the duration and the impact of this diversity and openness. For some, it is a durable and beneficial phenomenon. For others, it is a temporary and pernicious

cious by-product of the securities markets evolution, which should not detract from the long-term trend of trading venue consolidation.

However, even the opponents of the trading venue diversity need to tread carefully. In effect, the trading venues diversity or, as the CEPS ISD report calls it “the contestability,”⁶ is the core premise and promise of ISD II, without which the Directive would lose its substance or even its very “raison d’être.”

The tree and the forest

The critical importance of the trading venues diversity is reflected by the extraordinarily narrow focus of the ISD II discussions. While the full draft contains 67 articles, the overwhelming majority of comments and polemical exchanges - whether during preliminary public hearings, drafting process within the Commission or Council and Parliament discussions - dealt with two articles only* :

- Article 25, which defines the conditions of pre-trade transparency
- Article 20.4, specifying the limit order routing

Furthermore, within the theme of trading venue diversity, the public debate has converged with a laser-like intensity on a single topic, **the internalisation**: the ability for large financial institutions to match orders for securities transactions without using a recognised stock exchange market.

The debate about internalisation draws extensively on theoretical arguments and scholarly literature about the market quality, the best execution, the investor welfare, etc. However, this is not an academic deliberation. Intellectual rigour is often superseded by passionate advocacy. To the extent that the conceptual arguments and empirical evidence are far from conclusive, they can be (and have been) used to support diametrically opposed conclusions.⁷

Although the internalisation question is important, it does not fully exhaust the trading venues diversity theme. The internalisation tree should not hide the trading venue diversity forest. It is essential to explore the other dimensions of trading venues diversity, in particular the role of information technology and the changing nature of financial markets. But before that, we need to better understand the stakes of the on-going debate. What is really being argued here is the **role of the European stock exchanges** in the emerging landscape of securities markets. More bluntly, the key question is to what extent the exchanges and the financial intermediaries are now in competition with each other.

Changing role of the stock exchanges: from co-operative to corporate model

The profound changes of the European securities markets entailed a wholesale overhaul of the economic structure of stock exchanges. From an organisational perspective, they have been heavily modernised, in order to facilitate the evolution from local to national and international markets, and from physical infrastructure to electronic infrastructure. Their range of products and services has been considerably expanded. Their management has become more professional and therefore more autonomous from their traditional owners, the financial intermediaries, who were also their main customers. From

* One and a quarter to be precise

the governance perspective, they have evolved from a co-operative to a demutualised model.

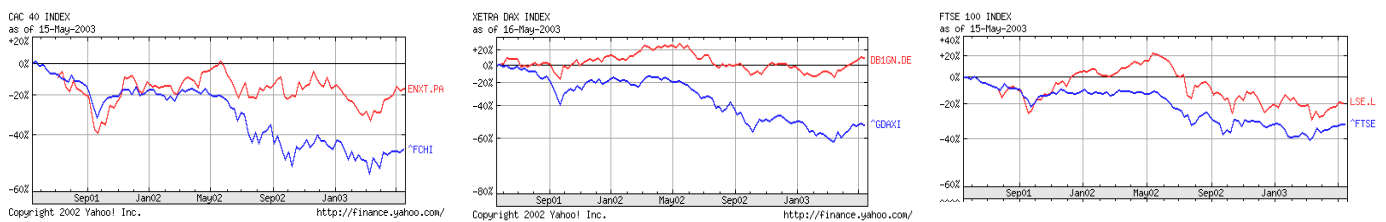
The European exchange model

Modernisation and professionalisation are not specific to the European exchanges. North American and Asian exchanges followed a similar evolution. However, the European exchanges, particularly those on the Continent, have developed additional characteristics, which gave them a distinct economic profile. Thus, exchanges such as Euronext and DBAG display a high degree of horizontal and vertical integration. They cover both cash and derivative products and they offer a full range of services, from pre-trade market data, through transaction to post-trade clearing and settlement. They operate in several national markets. Last but not least, all major European exchanges are listed and have at their disposal considerable capital resources. They seek to put these resources to good use and developed corporate growth and acquisition strategies.⁸

In short, the European exchanges have become full-fledged financial services enterprises, engaged in broad business and market competition. While their official communication stress the competition *among* exchanges (Euronext vs. LSE vs. DBAG), it is becoming more evident every day that the economic dynamics create a growing rivalry *between exchanges and their major users*, banks and securities brokers and dealers. The exchanges have become more efficient and richer than great many of their erstwhile owners. In particular, they are considerably more advanced in the deployment of cross-border financial services.

Many investment professionals consider major European exchanges to be well-positioned to take advantages of the opportunities created by the on-going transformation of European financial markets. This is not just a theoretical view. Over the last two years, the three major European exchanges, London, DBAG and Euronext, have all performed better than the broad indices of their core markets (see Graph 1 below).

Graph 1. European exchanges and their “home market” indices



Euronext and CAC40

DBAG and DAX

LSE and FTSE100

Source: Yahoo Finance

Some financial institutions begin to see their relationship with exchanges as a zero-sum game, where the revenue and profitability gains of the latter come at the expense of the former. It is interesting to note for instance while the US exchanges transact significantly higher amounts in their core equities markets, European exchanges such as Euronext and DBAG have higher absolute revenues and higher profits (see Table 1). This would suggest that the latter have managed to extract a higher share of securities value

chain revenue from their customers than their US counterparts.* The “zero-sum” view is not widespread but has been explicitly articulated during the ISD II debate by such important intermediaries as the Deutsche Bank (see below).

Table 1. Major European and American Securities markets: key data

	Share traded 2002	Share Value traded 2002 ¹	Market Cap (May 2003) ²	Revenues (FY 2002) ²	Income (FY 2002) ²
<u>Europe</u>					
Euronext	80435,0	1988358,6	2479,0	996,6	219,3
DBAG	68045,0	1212301,6	4640,0	1106,5	351,2
LSE	922328,7	4001339,9	1396,5	331,7	114,21
OM	63988,0	279943,5	495,3	285,9	32,9
<u>US</u>					
NYSE	363135,9	10311155,7	NA	954,2	36,3
NASDAQ	441666,0	7254594,3	NA	689,2	37,2

¹ In MUSD ² in MEuros

Sources: FIBV, Annual reports

Wither concentration rule?

The new competitive landscape has triggered demand for a level-playing field. In the past, exchanges were given what some considered a privileged and protected status, in recognition of their role as central marketplaces and price discovery mechanisms. Thus, ISD I directive allowed the selective (on a country basis) adoption of the concentration rule. It should be stressed that this was not a universal obligation. In countries such as UK and Luxembourg, the concentration rule did not apply.

Eight countries, in particular France and Belgium, enacted the “concentration rule” legislation. Paris and Brussels exchanges, constituent members of Euronext, firmly believe that this legislation supplied a vital support to their ultimately successful effort to repatriate the order flow, which in the 1980s had been captured by London’s SEAQ International. It could be argued that the concentration rule played only a minor role in the repatriation, which was due primarily to the massive modernisation efforts of the exchanges, combined with the persistence of “home preference” among investors.⁹ Nevertheless, the general perception was that, by allowing the adoption of the concentration rule, ISD I did contribute to the renaissance of continental exchanges.

One of the conceptual assumptions of the ISD II is that the concentration rule is no longer justified, as:

- Public goods of market transparency and efficient price formation can be achieved through alternative approaches
- Regulated markets are “for profit” entities and do not need specific protection.

Furthermore, ISD II promoters argued that the existence of national “concentration rules” prevents:

* The argument that the data are not comparable as European exchanges operates a more diversified activities mix is true but it also highlights the competitive advantage of some European exchanges which were able to expand, organically or through acquisitions, into activities deemed profitable from their strategic interest viewpoint. It should also be noted that trading commissions in Europe are considerably higher than in the US: 0.13% of the average value trade in Europe vs. 0.02% in the US (in early 2003).

- The emergence of a common trading environment by freezing channels for order-execution and perpetuating divergent trading conventions
- The competition between various trading methods to support different investor needs.

Thus, under ISD II legislation, national “concentration rules” would no longer be authorised.

Internalisation debate

Polarised views

These assertions and proposals did not go uncontested. In fact, the internalisation debate should be seen as a proxy for a spirited and protracted argument, backed by an array of academic studies, about the respective merits of concentration and fragmentation. In a study commissioned by the European Commission and published at the same time that the ISD II proposal, London Economics developed arguments against concentration:

- Concentration does not result in significantly lower spreads;
- Concentration markets have higher explicit trading costs (brokerage commissions, fees)
- Concentration is associated with lower market capitalisation and turnover;
- Concentration prevents competition between trading methods.¹⁰

Its proponents, such as Euronext, decried the negative consequences of fragmentation:

- Lack of transparency for the investor
- Impossibility to guarantee the best execution
- Suboptimal price discovery process
- High trading costs.¹¹

For many observers, the concentration-fragmentation argument exhibits a strong “time warp” flavour and sounds quite similar to the earlier battles over the respective merits of order-driven vs. market-driven market models, which raged across Europe in the 1980s in the aftermath of financial markets deregulation and in the run up to ISD I. The “usual suspects” were to be found on the opposite sides of the conceptual divide.

The usual suspects

Not surprisingly, City of London participants argue against concentration. London Stock Exchange is locked in a competitive battle with Euronext and DBAG and sees the removal of the concentration rule as a way of reducing an undue regulatory advantage. Moreover, although London Stock Exchange has introduced an order-driven matching system, SETS, which gained widespread market acceptance and now captures close to 65% of LSE transactions,^{*} market-making is alive and well in the City. It is not only a matter of well-established tradition but also the result of the massive presence of US bulge brackets investment banks - Merrill Lynch, Goldman Sachs, Morgan Stanley and Salomon Smith Barney -, which are eager to leverage their block-trading and internalisation skills acquired in their domestic markets in the European environment. Those banks also have a long-standing interest in Alternative Trading Systems (ATS). Many of them have been active shareholders in the ATS entities in US and in Europe.

^{*} In May 2003. SETS is steadily gaining market share: in May 2002, it accounted for 60% of eligible trades.

On the European continent, French market participants have been the most vocal advocates of concentration. Large French banks have no real tradition of market-making and do not intend to facilitate further inroads of US investment banks into the European financial markets. As founding shareholders of Euronext, they support its strategy. Also, they are rather sceptical about the need for ATS in Europe. In its Position Paper on ISD II, the French Banking Federation puts forward two guiding principles for the assessment of the proposal:

- Similar treatment for similar function
- Strong transparency requirements, both pre-trade and post-trade.¹²

Thus, FBF supports the pre-trade transparency requirements for internalisation, as formulated in Article 25. But it is Euronext that has taken the lead in the fight against the potential evils of fragmentation. It vehemently criticised the proposed elimination of concentration rule.¹³ In order to limit the risk of fragmentation, it strongly supports the current wording of Article 25, which specifically aims to circumscribe the spread of internalisation, by making it more onerous.

Other continental European exchanges, such as DBAG, have adopted a subtler approach. Their intent is to make order execution on recognised exchanges more attractive, through:

- Making it de facto default destination, particularly for the limit orders
- Giving exchange-executed order the generic seal of “best execution.”

...but some surprises

However, a closer look reveals that, beyond its “déjà vu” flavour, the argument about concentration and fragmentation reserves some surprises. Some market participants have significantly changed their position and adopted a “zero-sum game” view of concentration. This is the case of German banks, in particular of the biggest and most prestigious one, the Deutsche Bank. Traditionally, it has been a strong supporter of DBAG, the pillar of Frankfurt Finanzplatz. Yet, in the ISD II discussions, the bank has firmly endorsed the need for internalisation and rejected what it considers to be excessive requirements of the article 25 for pre-trade transparency.¹⁴ The rationale for this position is the need to reduce securities transaction costs. The bank considers that the DBAG order routing often imposes higher overall transaction costs (not only trading but also clearing and other charges) than the internally routed orders. It should also be noted that Deutsche Bank sold its entire shareholding in DBAG.

This is not an isolated position. Two other German banks, Dresdner and Commerzbank took significant shareholdings in NASDAQ Deutschland, launched in March 2003 with the explicit objective to compete with DBAG for the German equities order flow.

Large banks in other countries have not formally adopted a “zero-sum” view of exchanges as actual or potential competitors.* Yet, the question is the subject of intense in-

* However, it is worth noting that Mr. Wim Mijs, Chairman of the Financial Markets Committee of European Banking Federation (FBE) and SVP of ABN Amro, expressed support for internalisation in his tes-

ternal debates, often creating paradoxical situations. Thus, BNP Paribas has officially endorsed the Euronext position on internalisation and the FBF view on pre-trade transparency*, at the same time that its Securities Services arm launched a strong attack on Euroclear, a key component of the Euronext post-trading infrastructure, accusing it of unfair competition and excessive charges.¹⁵

Inconclusive debate

Despite the barrage of studies and arguments, the debate on internalisation remains inconclusive. After a comprehensive of research in the US and in Europe, the CEPS report on the topic concludes:

“ [...] whether fragmentation is harmful or not has been the subject of much debate and empirical testing, with so far inconclusive results. On the central issue of market quality and execution quality, some studies find that the increase in off-exchange order execution results in harmful fragmentation, other studies fail to document any harmful effects while yet other studies find beneficial effects on market quality. Research therefore provides support for both those who fear the negative effects of off-exchange order execution and those who claim it is supplementary to exchange trading. In short, research on the potential harm of fragmentation is not conclusive.”¹⁶

Various forms and shapes of internalisation

Questions of definition: Marketmaking, in-house matching or off-exchange trading?

There are several reasons for this inconclusiveness. One of the main reasons is the definitional ambiguity. Internalisation is not a homogenous, monolithic concept. It is a “broad tent”, extensible notion covering markedly different operations and approaches. Authors of the ISD II proposal sought to acknowledge these differences and to introduce pertinent distinctions. Thus, during the initial discussions, Euronext suggested to distinguish between “systematic” and “periodic” internalisations, based on the percentage of transactions internalised by a given financial intermediary. After extensive public discussions, Commission officials concluded that this was not a workable distinction and did not include it in its published draft proposal. It is also quite symptomatic that the “Scope and definition” section of the proposal does **not** contain a formal definition of internalisation.

What are the various forms of internalisation?

Most commentators refer to it as an activity of large broker-dealers, (with US “bulge brackets” banks immediately coming to mind) “which may execute client orders internally against proprietary trading positions.”¹⁷ By extension, broker-dealers internalise when they execute block trades for their institutional clients. Another instance of inter-

timony to the Economic and Monetary Affairs Committee of the European Parliament on 18 February 2003. He also mentioned that his views were backed by 16 out of 18 members of FBE, while French and Italian Banking expressed different views on pre-trade reporting.

* Mr. Pebereau, CEO of BNP Paribas, is Chairman of FBF.

nalisation occurs in price-driven markets of multiple market-makers, such as NASDAQ, where client orders are executed against market-makers inventory.

Internalisation is also sometimes defined as “in-house order-matching.” This definition implies that, contrary to the definitions presented above, the “internalising” intermediaries do not act as counterparties (dealers) but simply broker opposite orders of their clients. According to a still another definition, internalisation is meant to cover **all** forms of off-exchange trading. This is the approach adopted by Biais and Davydoff, who state in their paper on the topic:

“ Internalisation refers to the execution of customer trades by financial intermediaries off the primary market.”¹⁸

These definitions do not appear to dovetail with each other and do not form a coherent whole. They fail to acknowledge essential differences between dealer-based internalisation and internalised matching, both in terms of operational conditions, such as the capital commitment, and of regulatory implications. In the case of broker-dealers, the definition creates a real risk of confusion between “internalisation” and other activities, which are part and parcel of their business. What is the difference between an “internalised” transaction and the market-making, which is the core service of a broker dealer? The very definition of market-making, whether for institutional or for retail transactions, is trading for its own account: a market-maker is counterparty for each and every transaction it executes. In this sense, any price-driven market is partially or wholly “internalised”, whether it is regulated (NASDAQ, London Stock Exchange, options markets) or not (foreign exchange). It is somewhat paradoxical to read the accusations by Euronext that by promoting internalisation, large broker-dealers want to substitute for exchanges, when the major difference between the two is precisely the ability of dealer-brokers to act as principals, while the exchanges can only act as brokers.¹⁹ It is difficult to escape a conclusion that what is really being questioned by Euronext and its supporters is the market-making model of securities trading. The conflict of interest charge leveled against internalisation arises from the faculty given to broker-dealers by market regulators to deal for their own account as well as for their clients. Potential for such conflicts is increasing not because of attempts to internalise but because broker dealers seek to raise their returns on their expanding capital base through proprietary trading, where they act as their own clients.*

Internalisation debate thus appears to be the continuation, under a slightly changed guise, of the “order-driven” vs. “price-driven” market model controversy, which marked the evolution of the European exchanges during the late 1980s and early 1990s. The main lesson, both from various studies and from the actual development of securities markets, is that *these models are not mutually exclusive*. While the order-driven model has proved remarkably successful for trading of blue-chip equities, less-liquid and often volatile shares of smaller companies or some derivative products are more appropriately

* This capital expansion is a response to regulatory risk prevention and management pressures. Furthermore it should not be assumed that matching systems are exempt from conflicts of interest, although such conflicts may have different roots. For instance, pure brokers, who derive their income from trading commissions, have strong incentives to encourage their customers to trade more frequently.

handled through market-makers. Furthermore, market-making encompasses a range of activities: there are highly significant differences between, for instance, NYSE specialists, NASDAQ brokers-dealers and off-exchange block traders. In any case, market-making is generally acknowledged as a legitimate financial service that supplies essential liquidity to buyers and sellers of financial instruments. It is already subject to a close regulatory oversight. The need to adapt the regulation in response to new challenges is unquestionable. Whether mixing up internalisation, market-making and proprietary trading, and resuscitating an unresolved (and probably irresolvable) conceptual polarisation can be helpful in this endeavour is less clear.

In-house matching internalisation approach is an entirely different matter. It concerns primarily large financial institutions with huge retail order flows. These institutions are concerned with their execution costs and consider that by matching buy and sell orders internally they will eliminate what they consider to be an unnecessary intermediation for relatively simple transactions and thus reduce their costs. This is the rationale for the support of internalisation by Deutsche Bank, discussed above.²⁰

This type of internalisation is frequently lumped together with external matching systems operated as ATS (such as ECN in United States). The regulatory concern raised by ATS is that of market quality: by withholding some transactions from public display, as provided by exchanges, non-exchange matching distorts the perception of the actual depth and liquidity of the market. As a result, investors are not sure to obtain the best execution. To address this concern, operators of ATS offer the guarantee of execution at the best price available. Thus, ECN such as Island execute transactions after comparing prices within their order books and those offered by the most competitive NASDAQ marketmakers. Furthermore, many of them display their prices and make them available to market data vendors. Certainly, the NASDAQ – ECN experience to date does not support the view that the emergence of alternative trading venues and resulting fragmentation impairs the market quality. To the contrary, ECN have contributed to the substantial reduction of bid-offer spreads.*

Matching systems, whether operated by a single institution or as ATS, require regulatory safeguards to ensure that their users obtain best execution and that transactions within these systems contribute to the efficient price discovery. It is a matter of judgment whether internalised matching and collective matching systems should be subject to the same constraints of transparency and disclosure or whether they should be subject to different regimes. Furthermore, it is not certain that such a judgment can be made once and for all and thus enshrined into the framework legislation or would better be handled in more flexible and adjustable manner through Level 3 measures. But in any case, once regulatory safeguards are put in place and enforced, there is no inherent rea-

* The reduction of spreads should not be attributed to the ECN alone. Decimalisation has played as important if not even more important role. Nevertheless, ECN has gained market share of NASDAQ stock trading as a result of the spread reduction. It is therefore difficult to argue that they led to lower market quality.

son to believe that the overall market quality will be lower in a multi-venue configuration than in a monopolized and/or centralized setting.

The debate on internalisation thus mixes, without properly matching, three distinct questions:

- The general merits of market-making
- The rationale for alternative trading systems which compete with the established exchanges
- The order flow and transaction management strategies of large financial institutions.

These questions are undoubtedly interrelated by the common threads of market quality and market transaction costs, but the debate would be certainly more productive if they were addressed explicitly and analytically rather lumped together in a passionate argument.

INFORMATION TECHNOLOGY AND MARKET TRANSFORMATION

Furthermore, academic and policy discussions of broad generic concepts such as market quality or market liquidity need to take into account more than they have done to date the increasing diversity and complexity of financial markets. Impressive quantitative growth over the last thirty years made the markets “unbound” and ubiquitous, and begot qualitative transformations.²¹ Their traditional role as a channel for raising and allocating capital among business issuers and borrowers has been immeasurably strengthened. Capital raising through financial markets is no longer restricted to a handful of blue-chip companies in traditional industrial sectors but expands across the range of firms’ size and covers the full spectrum of economic activities, from start-up in emerging sectors through privatisations in emerging markets to consolidation in mature industries. At the same time, financial markets have become a mass consumption phenomenon, reaching millions of retail investors. They acquired a new dimension as an essential channel of collective investments supporting long-term saving and retirement schemes. In Europe, this dimension is likely to grow significantly in the coming years.

The range of listed and traded instruments was greatly expanded to accommodate a greater variety of issuers and investors. Financial product innovations came in successive and cumulative waves: derivatives for single equities and for broad indices; instruments to manage market and credit risk exposure; mutual funds and other forms of portfolio investments such as Exchange Traded Funds (ETF). These innovations account for a significant share of the impressive growth of financial markets and transactions. Financial markets expand not only across business segments and product categories. They also spread across geographical space and national boundaries. The share of cross-border trading is constantly growing.

Information technology and financial markets: Widespread misunderstandings

Underpinning the financial markets transformation is the massive use of information technology. Technology has made possible the scalability of transaction volume and the global reach. It dematerialised physical markets into virtual ones. It provides the required design and development tools for new financial instruments, and the system and

network infrastructure to transact them. It allows the development of new trading models and structures.

The relationship between information technology and financial trading mechanisms is the subject of repeated and widespread misunderstandings. It was long thought that the technology limits the choice of trading mechanisms and tends to privilege some mechanisms over the others. Some have argued for instance that the computerised trading cannot accommodate complex transactions and/or non-standard instruments. These supposed limitations explained the hatching difficulties experienced by early promoters of computerised systems for OTC or derivatives (Globex, for instance) during the 1980s. Others have looked at the prevalence of order-matching systems among continental European exchanges as the proof that this is the optimal computer trading model. Both of these views suffer from the technological myopia and ignore the flexibility and the rapid evolution of information technology.

From the very beginning of its large-scale use in financial markets, information technology accommodated different market models and structures. During the 1980s, it supported both price-driven (NASDAQ) and order-driven systems (Toronto CATS). It also accommodated various crossing networks for institutional transactions (POSIT and Instinet).

In the 1990s, internet technologies further expanded the range of market applications. They have been used to develop a variety of auction mechanisms in B2B markets for large industrial corporations (Covisint, Freemarkets) and to create electronic markets for wholesale fixed income transactions (E-speed and BrokerTec). In the coming years, the pace of trading mechanisms innovations is likely to further accelerate, as finance professionals and IT specialists converge in their efforts. All markets, regardless of their structure and instruments traded, are becoming electronic. And far from making markets uniform, information technology accommodates and actually stimulates variety and diversity of trading models and mechanisms. The abundance of information, opportunities and relationships increases the need for new intermediation mechanisms. The challenge of technology to the financial institutions and services providers active in financial markets is not the disintermediation but the changing nature of intermediation.

Securities value chain: from consolidation to interconnection

Technology touches all aspects of securities markets, not only trading but also post-trade processing (clearing, settlement and custody administration) and information dissemination (both pre and post-trade). Its impact has been particularly significant and visible in the domain of market information. Technology democratised market access by making price and company data available widely and quickly. As result, market data distribution companies such as Reuters, Bloomberg or Thomson Financial have become major players in financial markets and came to be seen as competitors to their main customers, financial institutions.* Already apparent during the 1980s, the data democratisation was amplified by the internet, which dramatically lowered the price of market information. Real-time market data sold in the mid-1990s for several thousands (or tens of thousands) euros per months are now priced at few euros or sometimes distributed for

* Which were also their primary data suppliers!

free. Today, a retail market investor has a quicker access to market data and information about quoted companies than a professional investor had few years ago. The democratisation of financial information was a major factor in the surge of the retail equity culture both in the US and in Europe in the late 1990s.

Technology has also profoundly affected the articulation between pre-trade, trade and post-trade segments of securities value chain. Initially, it facilitated consolidation and concentration of pre and post-trade activities. Thus, in the US in the 1970s and 1980s, the main stock exchanges have pooled their resources to create a consolidated market price (ticker) information distribution plant (CTS) and common clearing and depository facilities (NSCC and DTC), which provide a clearing and settlement infrastructure for practically all US securities transactions.

Over time, as users became more familiar with the technology, they sought more flexible and decentralised arrangements, allowing them a greater control of specific segments of the securities value chain. Such search and control have been made considerably easier in the internet environment, characterised by ubiquitous networks and standardised data exchange procedures. In this environment, traditional distinctions and trade-offs between centralised and distributed systems basically lose their pertinence. In other terms, it is no longer necessary to concentrate all the data in one huge database to ensure their consistency and comparability. In the similar way that in an electronic market a transaction can be executed among counterparties who are physically remote, a user can easily obtain a range of data from various markets aggregated by an information provider or can even aggregate the data herself. In a networked world, it does not really matter whether trading and information systems are centralised or distributed as long they are interconnected and their underlying data standardised. And **interconnection and standardisation** are becoming the market rule rather than the exception.

Consolidation and proliferation crosscurrents

A closer appreciation of relationships between information technology and financial markets sheds a new light on the question whether the securities markets will tend to consolidate or to proliferate. The answer cannot be unequivocal as the evolution of the markets is marked by crosscurrents: consolidation and proliferation are therefore likely to coexist.

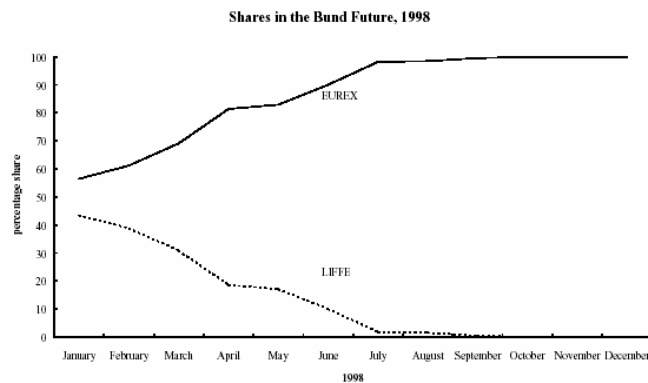
Network effect and concentration

On the one hand, financial markets have been subject to a strong concentration pull. Financial markets evidence large network externalities, which create economies of scale. Both buyers and sellers are attracted to markets, which offer the highest probability of finding counterparties. In turn, greater order volumes lower unit transaction costs, which create an additional incentive to trade. Technology further facilitates this trend by reducing the cost of access to markets. According to an old market saying, "Liquidity begets liquidity," and, as a result, liquidity pools tend to become larger.²² This network effect explains the limited success of multiple listings. Transaction orders for a given equity issue or a derivative instrument tend to flow to the most liquid market.

This does not mean that the liquidity cannot shift. Market participants can change their preferences for strategic reasons and are sensitive to large transaction cost differences. There have been some instances of massive and rapid displacements of liquidity pools.

Thus, in the 1980s, large transactions in blue-chip stocks listed on continental exchanges migrated to SEAQ International in London. In the 1990s, the continental exchanges were able to recapture these transactions. Probably the most spectacular case of a liquidity shift was the recapturing of the bulk of bund futures trading by Eurex from Liffe in the mid 1990s.

Graph 2. Bund future evolution



This is however a rare case of a victory of a contender that started with the lower market share. Most of the time, the order flow displacement favours the largest market and tends to accentuate the imbalance to the point where smaller markets become uneconomical. In France and in Germany, main national markets have marginalised regional markets and in the US, despite the determined effort of the Securities and Exchange Commission, the New York Stock Exchange towers over regional exchanges.

Innovation and market proliferation

The trend to concentration is unmistakable. Yet, practically simultaneously, successive waves of innovation lead to a proliferation of new markets and also to a more intense competition within the existing markets. New instruments entailed the emergence of new markets: During the 1980s, an entire family of financial derivatives markets was born. While some of them, such as Liffe and Soffex (Eurex), were later acquired by traditional exchanges, others such as Chicago Mercantile Exchange in the US and the OM in Sweden, have kept their independence and embarked on ambitious expansion strategies.* A new options exchange, International Securities Exchange, based on a fully electronic auction model, was launched in 2000. In early 2003, ISE became a market leader in individual equity options, ahead of CBOE and ASE.

Internet triggered a new generation of markets, both financial and non-financial. In financial area, there was a new generation of ECN (Island, Archipelago) and the emergence of trading venues for traditional instruments such as bonds (e-Speed, BrokerTec) or foreign exchange (FXall, Currenex). In non-financial area, several thousands B2B exchanges were launched. While the majority of Internet-based market initiatives have

* It can be plausibly argued that OM constitutes the original prototype of the European exchange model. It was launched as a private for profit business and it was the first European exchange to go public. It covers a variety of instruments and value chain activities. It has established a strong position as a supplier of technology both for traditional and new markets (B2B for instance). And, last but not least, it operates across borders. It trades across Scandinavia and offers its technology worldwide.

failed and many are consolidating, enough remain to constitute a significant factor in the evolution of markets.

Moreover, the internet modified the competitive structure of traditional markets, particularly but not exclusively that of NASDAQ. Not only ECN captured significant market share but new trading systems have been launched, whether by NASDAQ (Super-Montage) or by leading intermediaries (Primex).

Coexistence and multipolarity

Both centripetal consolidation and centrifugal proliferation trends are likely to continue their uneasy and far from peaceful coexistence. Contrary to conventional wisdom, the globalisation and automation do not eliminate diversity and heterogeneity; to the contrary they allow financial markets to accommodate them. It is widely thought that the consolidation of the exchanges is far from over. Yet, at the same time, the notion of a single European exchange appears neither politically feasible nor economically desirable. As a reference point, it can be noted that the development dynamics of US equity markets resulted in a multipolar structure, organised around three major poles: New York, NASDAQ and Chicago derivatives markets. In Europe, it is also likely that there will be at least two and probable more significant securities market poles. In addition, there may be other market initiatives, launched both to directly compete with the traditional exchanges and to accommodate new waves of financial innovations.

As a result, financial markets structure will remain unstable and dynamic, its perimeter and competitive dynamics incessantly evolving. The major challenge to the European financial markets stakeholders is not the consolidation but the **interconnection**: creation of common rules, standards and infrastructure links across various markets.

ISD II ARCHITECTURE AND INNOVATION

Regulatory approach: the US reference

In spite of significant differences between the US and European contexts, the evolution of the regulatory framework for the US securities markets provides a highly relevant reference for European ISD efforts. It is difficult to argue with success, and, despite crashes and accidents, US financial markets remain remarkably vibrant and dynamic and, above all, central to the US economic performance. The main US markets regulator, the Security and Exchange Commission (SEC), proved both forceful and articulate in its approach to market regulation.* Its initiatives and arguments have been closely monitored by the European authorities and policy analysts.

SEC has long recognised both the benefits of the competition and the crucial role of technology in market evolution. It consistently sought to stimulate inter-market competition among exchanges, by eliminating restrictive rules and regulations, which favored the New York Stock Exchange and by promoting the National Market System (NMS). As noted above, these efforts have only been partially successful as NYSE maintains its dominant position within the NMS.

Overseeing technology deployment

* Although its recent internal and public setbacks show, if need be, that nobody is perfect.

SEC appears to have been more effective in overseeing the deployment of technology and preserving a fragile equilibrium between competition and co-operation. It thus facilitated the introduction of shared facilities such as the CTS and DTC/NSCC. At the same time, it stayed away from heated discussions about the respective virtues of order-driven (NYSE) and price-driven (NASDAQ) market models and allowed their, more or less peaceful, coexistence. The acceptance of price-driven or market-making model necessarily entailed the acceptance of internalisation, which has been long practiced by leading NASDAQ participants. More generally, SEC has adopted a flexible attitude toward order routing by intermediaries: it allowed payment for order flow practice and upstairs trading for block transactions.²³

SEC has been quick to appreciate the potential of internet technologies as a vector of trading system innovation and a spur of greater market competition.²⁴ In April 1999, it adopted the [Regulation ATS](#) (Alternative Trading Systems), creating an intermediate market participant category – with eligibility criteria more rigorous than for broker-dealers but less onerous and simpler than for full-fledged exchanges. The combination of market impetus and regulatory support stimulated a rapid growth of ATS or, as they are commonly called, Electronic Communication Networks (ECN). ECN were not a new phenomenon in the US markets. They were launched in the 1980s in response to the needs – such as after-hours trading, large order matching for institutional investors or support for market-makers for position management - to which the established stock exchanges were unable to respond in a satisfactory manner. However, until the advent of the Internet and the enactment of Regulation ATS, they remained however relatively marginal as their access was restricted; their technology, proprietary; and their prices were not widely disseminated.

By the late 1990s, a new category of ECN emerged: Island, Archipelago, Redibook. They were based on internet technology and sought to capture the retail order flow generated by online-brokers. Their competitive advantage was the ability to match orders directly and thus reduce or even eliminate market-makers spread. Furthermore, their use of Internet made access, terminal deployment and wide data dissemination economically and operationally efficient.

By late 2002, ECN have captured close to a half of trades on NASDAQ-listed stocks. In response to ECN threat, NASDAQ has launched in October 2002 a new system for centralised price comparison, order routing and matching, SuperMontage. Aggressively priced, SuperMontage is expected to regain business from the ECN. In turn, ECN have adopted new strategies, which seek to mitigate this threat. Thus, two ECN, Archipelago and Redibook merged in December 2001.²⁵ Archipelago has merged with Pacific Stock Exchange to become a fully fledged regulated market. In 2002, in a highly symbolic act, Island, the leading Internet-based ECN, took over the first generation ECN leader, Instinet.

ISD II: The new architecture

During the elaboration of ISD II, the need to introduce a new category of financial intermediary has been extensively discussed. Many participants asserted that in the European context, there is no need for Alternative Trading Systems, given the efficiency of

order-matching of major exchanges. In fact, neither traditional (Instinet) or new ECN nor ATS have been able to achieve a significant foothold in the European markets. However, regulators scrutinised ATS closely and CESR published in mid 2002 a consultative document on the topic.²⁶

After extensive internal and external discussions, the ISD II draft proposed to introduce a new category. Thus, under the proposal, there will be three major categories of entities providing investment services:

- Regulated markets
- Investment firms, which under certain conditions can “internalise” their transaction flow
- Multilateral Trading Facilities (MTF), a new core service.

Regulated markets: end of exceptional treatment

Some exchanges see ISD II, in particular the elimination of the concentration rule, as an assault on their position. Yet, this view deserves to be significantly nuanced. Probably the most significant feature of the proposed regulatory rules and requirements for regulated markets is what they do **not** do. The new framework does not impose major constraints on the scope of activities and services of regulated markets. Contrary to explicit demands of some participants in the ISD consultations, the proposal does not preclude vertical integration between trade and post-trade activities. It explicitly authorises regulated market to offer MTF (see below). In the recognition of the changing role of stock exchanges and their new competitive posture, it would appear that the ISD II proposal seek to bring the regulated markets within the common purview of financial regulation. Maybe ISD should be called Exchange Emancipation Directive.

Investment firms: Off-exchange trades & internalisation

This is the most controversial part of the ISD II framework. Authors attempt to trace a “third way” between those who refuse to legitimise what they consider as fundamentally unsound habits and those who believe that no undue restrictions should be imposed on the well-established market practices. Their approach is to emphasise measures to protect investors such as:

- Conflict of interest disclosure and management
- Best Execution: Broker-dealer cannot internalise client order unless this amounts to the best conditions (net price) for the client. Order-handling must lead to expeditious and favourable execution.
- Client consent: financial intermediary has to obtain prior consent before executing orders off-exchange. Such consent may periodical or trade-per-trade

In order to promote market efficiency and liquidity, the directive proposal imposes trade disclosure requirements. While post-trade reporting is generally accepted by market participants, pre-trade transparency (Article 25) is the epicenter of the controversy. This controversy has gone beyond business consideration to enter the political realm. Its legislative outcome is therefore hard to predict. In any case, the controversy and strong disagreements are likely to persist at all level of subsequent ISD II implementation

MTF: A major innovation

While less visible than internalisation, MTF is a real innovation of the ISD II proposal. The goal here is not to codify an established business practice but promote a new competitive dynamics.

It is worth considering the choice of name for the new core service. Why have the ISD II draftsmen did not choose the well-established term of ATS, which has been used not only by the SEC but also by the CESR. Authors of the proposal explain their choice in an endnote as follows:

“ The term “alternative trading system” (ATS) has entered into common parlance as a catch-all term for a wide range of new trading support facilities whose shared characteristic is that they are not licensed as exchanges. Some respondents to the consultation have noted that this terminology is not suitable for a legal text and does not capture the specific functionality of the entities which it is proposed to authorise as a new core service. In view of this, the term “alternative” has been replaced by “multilateral”. The word “system” is replaced by “facility” – to avoid confusion with a well-established bond-trading outfit [MTS].”²⁷

This explanation is fairly straightforward. And most analysts tend to use the terms of ATS and MTF interchangeably. Nevertheless, there are subtle but significant distinctions in the meaning of the two concepts:

- **Alternative Trading Systems** refers primarily to systems that deal in equities, compete with exchanges for order flow and focus on active retail investor. In the internet parlance, it is a B2C concept.
- **Multilateral Trading Facilities** have their origin in the world of derivatives. The term has been initially used by the US regulator for derivative and commodity markets, Commodity Futures Trading Commission (CFTC) in the context of new regulatory framework proposal for the future markets.²⁸ The main focus of MTF is the over-the-counter market for financial professionals. It is a B2B concept.

MTF concept introduces two new dimensions in ISD II:

- Trading venues for new and non-standardised instruments,
- Competition between exchanges and financial over-the-counter (OTC) markets. These markets are well-established and considerably larger than the regulated markets for equities. For instance, according to ISDA (International Swap Dealer Association), as of the end of June 2002, interest rate and currency derivative contracts outstanding were valued at \$82.7 trillion; credit derivatives, at \$1.6 trillion; and equity derivatives, at \$2.3 trillion. Furthermore, the OTC markets continue to grow rapidly.

While the primary purpose of the OTC markets is risk management and transfer, regulators are increasingly concerned about the lack of oversight and the potential for systemic risk. In its comments on ISD draft, the European Central Bank notes that transparency requirements deal with equities only and do not cover other listed instruments such bonds or mutual fund. ECB recommends the extension of transparency regime to these instruments. They even suggest to bring the trading of these instruments within the purview of regulated markets.²⁹ This may be a tall order. ECB and other regulators fully realise that OTC transactions cannot be easily transferred or migrated to the regu-

lated markets.* Hence, a search for new services, which would offer greater transparency and oversight than pure OTC transactions, but would be more flexible and less formal than the regulated markets. MTF can be seen as such a service.

MTF is defined by ISD II as follows:

“ A multilateral system which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract.”³⁰

MTF are subject to a tailor-made investment firm regime. This regime is quite close to that of regulated markets and covers:

- Organisational requirements and trading rules, subject to prior regulatory approval
- Transparent and non-discriminatory access to the facilities
- Market surveillance
- Pre and post-trade transparency.

There is however one critical difference: MTF does not require any rules on admission of instrument to trading. It does not have to follow the onerous and highly formalised listing procedure for instruments it trades. It therefore can trade any instrument, as long as its issuer is informed about MTF intent. Thus MTF can provide trading support to tailor-made, one-off instruments and transactions. It can of course trade listed instruments and compete directly with the established exchanges. In this case, MTF is synonymous with ATS. It would thus seem that while all ATS are MTF, not all MTF are ATS.

MTF however is not a pure trading facility, it can cumulate MTF operation with other core/ancillary services.

Who can set up and run MTF? Entry barriers and operating burden are higher than for investment firms. More fundamentally, MTF operator cannot intercede to facilitate trades or participate itself (against a proprietary trading book) in transactions with MTF users. According to the proposal:

“ There is no active or discretionary role of the system operator in pre-selecting, recommending or otherwise bringing together of trading interests. “

In other terms, a MTF operator will act as an exchange rather than as broker-dealer. The logical extension of this line of reasoning is that the most likely MTF operators would be the existing ATS and exchanges.* The ISD II explicitly states that regulated market operators can run MTF. For an ATS operator, MTF would offer a more robust and predictable regulatory set-up. For the exchanges, it offers an opportunity to leverage their skills and resources in a more flexible context.

The ATS and the exchanges are already locked into a competitive battle for new opportunities in financial markets. ISD II aims to codify the rules of this battle.

* However, some aspects of OTC are being brought within the purview of regulated markets. For instance, London Clearing House (LCH) set up a facility, SwapClear, that offer a central counterparty facility for swap trades. SwapClear is rapidly gaining market acceptance. Nevertheless, its promoters do not expect that all swap transactions will eventually be settled through CCP.

* According to the ISD II draft, In UK, some 29 entities are thought to fall within the scope of the MTF definition. DE is also home to a large number of these systems, while IT, BE, IRL, FR also have granted authorisations to MTF.

In light of the innovative character of MTF and its potential implications for the future of European financial markets, it is surprising how little attention the topic has attracted, particularly since the publication of the ISD II proposal. Compared to the “sound and fury” surrounding internalisation, MTF discussion has been eerily quiet.

And yet, MTF concept raises some crucial questions.

The first one is whether the proposed set-up creates *a level-playing field*. Isn't there a risk for the existing ATS that ISD II would raise regulatory hurdles too high by creating unnecessary constraints on access and trading mechanisms, and by imposing unrealistic transparency and disclosure obligations? It could be argued that the proposed distinction between MTF and regulated markets is too tenuous and should be sharpened. MTF should be defined more broadly and flexibly, to accommodate a wide and evolving range of instruments and trading methods.

A related question is whether MTF in its present form is *well-suited for OTC instruments* it is supposed to capture. The main reason for these not being traded on regulated markets is that financial intermediaries involved in OTC transactions consider transparency and disclosure requirements on these markets to be too rigid and exposing them to considerable market and operational risks. To the extent that MTF are not intended as compulsory trading venues (and they clearly are not), they need to find a right balance between the present *claire-obscur* of OTC transactions and the blinding glare of regulated markets.

PRELIMINARY CONCLUSIONS

Avoiding a middle of the road trap

The debate around the ISD II highlights the risks of a middle-of-the road trap. By seeking to accommodate conflicting interests, the ISD II proposal is attacked from all sides. For some, it is too prescriptive and dirigiste, for others, too flexible and laissez-faire. As the proposal moves toward its legislative enactment through the obstacle course of interactions between the Commission, the Council, the Parliament and the ISD “stakeholders”, the level of contentiousness is bound to further intensify. In early 2003, suggestions have been formulated to simplify and shorten the draft proposal, in order to bring it in line with the spirit of the Lamfalussy process and make it into the Level 1 framework legislation, dealing with high-level principles rather operational details.³¹ However, these proposals are unlikely to be retained. In a familiar pattern, technical analysis is increasingly yielding to political horse-trading. In order to reconcile differing positions, temptations to either fudge the critical issues or drown them in procedural details will be hard to resist.

Yet, for the sake of the credibility and effectiveness of Lamfalussy process, it is essential to seriously reflect, particularly at the Council of Minister level, on the meaning of the framework legislation. It would seem clear that such legislation should focus on principles which are common to all member states. This would entail a minimum rather than maximum level of harmonization. It would imply a degree of simplicity and abstraction, considerably higher than that of the existing draft.

One practical and short-term suggestion that could be made to improve the clarity of the legislation is to expand the Scope and Definition section of the law (Section I) and in particular Article 3 (Definitions) to include “internalisation” in its various guises and sharpen the distinction between internalisation, MTF and regulated markets.

Eluding the “rear-view mirror” risk

The basic problem of the present tenor of the ISD II discussions is that they tend to focus the stakeholders attention on the past rather than the future. There is a real risk that some of its most hotly debated provisions will become obsolete by the time ISD II is transcribed into national legislation or oversight regulation.

As ISD II progresses toward its eventual enactment, it is important not to lose sight of underlying policy issues and to pursue the substantive debate among market “stakeholders.” However, in order to reduce the level of conceptual confusion and quasi-religious polarisation that have marked recent ISD II discussions, and make more constructive and forward-looking, the debate needs to recognise the following:

- The European market evolution is still on-going. Major changes in product offerings, asset class coverage, participant perimeter and competitive structure are still ahead of us. These changes cannot be all anticipated: which expert predicted ten years ago that all major European exchanges would be listed by now?
- It is therefore important to ensure that the ISD II legislation does not impede the fluidity of this evolution and avoid the “rear-view mirror” risk. It should have built-in adjustment ability, particularly at the implementation and oversight levels.
- Information technology plays a critical role in market evolution. It has rendered obsolete the very foundation of many regulatory and institutional constructs. In the networked world, the notions of concentration and fragmentation are no longer irreconcilable opposites. These and related notions of transparency, liquidity and quality should be revisited and reassessed in light of their pertinence to regulatory concerns.
- The technological dimension, while not entirely absent, has not been given proper and explicit consideration in the process leading to the elaboration of the ISD II proposal. Nor it appears that it will be given appropriate attention moving forward. The current process of law and rule-making does not provide any forum or channel to systematically analyse interactions between information technology and financial markets. This gap entails a non-negligible risk that the policy-making process may lead to unrealistic recommendations and/or suboptimal results.
- Systematic efforts should be made by ISD II stakeholders to better understand the impact of information technology on financial markets and mechanisms and to introduce technological dimension in policy considerations. This implies that specific industry and inter-industry fora (whether ad hoc seminar or roundtables or longer-term working groups) should be set up to research and discuss this impact.

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ENDNOTES

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