



Market

Transparency:
Making Unfilled
Orders Public

This White Paper is part of a series of Equiduct sponsored research papers that aim to increase awareness of the impact of MiFID and to assist the financial community in the practical implementation of MiFID.

The opinions and views expressed in this White Paper are the personal opinions and views of the author.

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About Equiduct

Equiduct offers the first MiFID compliant, integrated Europe wide single connection for trading services and execution. Equiduct facilitates compliance in the post MiFID European marketplace by providing a single point of connectivity through its own pan-European regulated exchange, and through the provision of white label services to systematic internalisers or financial institutions that want to operate their own trading facilities. Equiduct's unique market model addresses the four key requirements of best execution, by enabling guaranteed execution at the lowest cost and at the best price in a less than 10 milliseconds turnaround time

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Specific legal advice should be taken before acting on any of the topics covered.**

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1. MiFID Requirement to Make Unfilled Orders Public

With the implementation of the Markets in Financial Instruments Directive (MiFID) in November this year come a number of wide-ranging changes that will have considerable impact on the securities industry across Europe. The main thrust of MiFID is to harmonise European securities trading and breakdown barriers, including the removal of concentration rules. This new legislation introduces opportunities for new execution venues and allows more competition in trading mainly through transparency obligations that go further than ever before in ensuring that information is published both pre- and post-trade.

One significant requirement of the MiFID articles on transparency is related to client order handling and the drive for limit orders to be made public. Orders that are not large in size, compared to Normal Market Size as defined in Table 2 in Annex II of the MiFID Regulation¹, have to be made public in accordance with Article 22(2) of MiFID Level 1.

This is not something that happens consistently at present and many would-be Systematic Internalisers (SIs), such as Retail Service Providers (RSPs) and others who internalise order flow and deal on their own account, do not consistently publish orders that are unfilled. This paper aims to highlight some of the challenges that SIs may face and to unveil the concerns that such pre-trade transparency may bring to these significant market participants.

**Extract from MiFID Level 1
Article 22(2)**

“Member States shall require that, in the case of a client limit order in respect of shares admitted to trading on a regulated market which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with this obligation by transmitting the client limit order to a regulated market and/ or MTF. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 44(2).”

The market is formed, most simplistically, of 2 types of pre-trade information: quotes and orders (although there are others including hybrid systems).

- **quote driven market**
Pricing is driven by designated Market Makers who provide the bid and offer prices they are willing to accept at the time along with a minimum size.

¹

Table 2
Orders large in scale compared with normal market size

Class in terms of average daily turnover (ADT)	(in EUR)				
	ADT < 500 000	500 000 ≤ ADT < 1 000 000	1 000 000 ≤ ADT < 25 000 000	25 000 000 ≤ ADT < 50 000 000	ADT ≥ 50 000 000
Minimum size of order qualifying as large in scale compared with normal market size	50 000	100 000	250 000	400 000	500 000

- **order driven market**

The market displays a list of orders from buyers and sellers detailing the security details, amount and price at which they would like to buy or sell. In these order driven systems there are generally two types of orders: limit and market.

Limit orders are of most concern to this article where a buy or sell order is placed at a better price away from the current best bid and offer (BBO). The market order is placed at the BBO and is generally executed immediately because a client is simply a price taker.

Limit orders generally drive liquidity and traders who use these sorts of orders are seen as price setters, driving for a better price than the market is offering. Regulators believe that when unfilled limit orders are visible they provide a critical service to the market by increasing information and allowing the market to determine what the fair value is. The result is that MiFID calls for unexecuted limit orders to be made public by publishing to a Regulated Market (RM) or a Multilateral Trading Facility (MTF)² in the belief that such disclosure will prevent the artificial widening of spreads, promote price discovery and lead to a more competitive market.

There is some truth in these statements. However, a Market Makers' competitive edge is based on their informational advantage and as a result they are able to take risk based positions in the market. Market Makers therefore drive liquidity and are able to manage spreads, whilst ensuring they make a profit. Force them to publish all unexecuted orders and suddenly it may well be that by giving out information their trading position becomes less advantageous and they are less inclined to take on positions. In effect, they may well decide not to quote in liquid shares and the market may suffer as a result.

Opposing this view, the Regulators believe that as long as the Market Maker has the unfilled order open and away from the market he/she has the ability to decide when to execute and therefore more time to determine whether they can profit from the order. They believe this is detrimental to the execution possibilities and the order should be opened up to more competition and market wide trading interests. Furthermore, some analysts believe spreads are narrowest when there is visibility of limit orders and that the visibility of unfilled orders provides liquidity to the market.

2. Reacting Quickly to Market Change

Investment firms that trade from their own order book face a significant challenge to their profitability post-MiFID and one that may only be solved by the ability to react extremely quickly. If a limit order is received and the market moves suddenly, owing to an announcement or sudden change in market sentiment, with fully transparent orders they could be left very exposed. Where the SI has a limit order executed as the market shifts they are inevitably left with a loss to bear. Indeed this could be a very costly situation and as a result an SI or RSP will benefit hugely from implementing systems that re-peg limit orders as soon as the market moves. Either that or they will simply not want to be involved in offering order services and risk taking potentially unwanted and expensive positions. Ultimately it is those with fast and agile trading systems that operate with extremely low latency who will benefit along with those market participants i.e. the RM who can offer exchange services that meet the needs of both on and off order book quoting.

² Article 31 of the MiFID Regulation states:

"An investment firm shall be considered to disclose client limit orders that are not immediately executable if it transmits the order to a regulated market or MTF that operates an order book trading system, or ensures that the order is made public and can be easily executed as soon as market conditions allow."

In addition to the potential loss from a sudden shift in the market, an SI may find that by publishing unexecuted limit orders they provide others with the opportunity to fill them. Often Brokers will place limit orders with RSPs or Market Makers but don't want them published – they are pure OTC and off-exchange (i.e. trading in dark pools on a negotiated basis). This service is afforded to certain clients who may well be using algorithmic solutions, such as Arid from Instinet, to sweep such dark pools of liquidity. They will go to the Market Maker and expect that if the market moves suddenly they can reposition their order. By dealing in the dark pool there is a certain amount of risk awareness that can be built into the order but if this is made public in a transparent market the risk assessment changes significantly. In a transparent market as the market moves to the limit order the order gets filled on a preferential basis and if the order is public it may well be that another dealer, with a faster system, fills it. Ultimately the Market Maker may lose out to a faster system and such risk needs to be built into the cost of trade and hence spreads may increase.

3. Keeping Others in the Dark

So, there are reasons for SIs to desire some form of opacity, especially around OTC trades, and because they currently have it they have built strategies and risk quantification around that. Unfilled orders, or unexecuted limit orders, are not something that investment firms like to make public, especially in very liquid markets and at times of high volatility. It shows their hand and can mean that those taking positions need to be very aware of market conditions to avoid being caught out by sudden shifts. Market Makers use their informed position to make a profit from the market and their confidence in the value of the stock along with volatility is directly related to the spread. If their entire order book is available to be viewed, others (including competitors) are able to infer market strategy, sentiment or other price information that reduces the profitability of Market Makers and the likelihood that they will not want to form market making positions in that stock.

Clearly MiFID does allow for some negotiated trading to take place but this is only when the order is 'large in scale'. Anything below this will have to be made public, whether it is OTC or not, and MiFID seems to recommend that such orders are delivered to a RM or MTF for publication. Again this reduces the likelihood that SIs will want to offer such services and this reduces their competitiveness. One key driver within MiFID is to remove the concentration rules, where certain transactions had to be executed on an RM thus creating more competition in venues and hopefully reducing the cost of execution. That is absolutely mirrored by the desire of investment firms to carry out more trades off-exchange and away from the order book: OTC trading reduces exchange fees and drives down costs. However, in effect the need to publish unexecuted limit orders (more than likely to an RM or an MTF) re-imposes such obligations on SIs and as a result one has to ask whether the cost of trading will be as competitive as MiFID would like.

The key question of course is whether new venues such as Equiduct and Turquoise will be able to gain a foothold in a market dominated by domestic institutions such as the London Stock Exchange (LSE) or the Deutsche Börse and regional institutions such as OMX or Euronext and operate an orderly and efficient market with low fees. Certainly, many firms have indicated a desire to take OTC trading away from the LSE to reduce their cost but the obligations of MiFID mean that the fees of the LSE will possibly be replaced by the fees of another venue, who may find the market immediately post MiFID quite a challenge. At the very least SIs will face the cost of communication for unfilled orders and if they do publish to smaller venues they face other challenges as well.

4. Algorithmic Trading and Policing MiFID

A final consideration is the position of algorithms, a growth area in the industry. With greater transparency these systems have more information on which to make decisions and ultimately could become more informed than Market Makers. Computers can react more quickly than humans to market movements and so more transparency, increasing the volume of orders, could stimulate a rise in algorithmic trading as systems fight for positions. Lot sizes will probably come down and this in turn will drive more unfilled orders being placed and again lead to further increases in the use of algorithms, may be at the expense of market making.

In this type of market those RMs and MTFs who are able to respond very quickly to market and price shifts will benefit. In a post-MiFID landscape of small lots speed will be a key differentiator and the number of orders will increase compared to trades. One exchange spoken to indicated that the number of orders currently on-exchange books across the EEA is perhaps 3 times more than the number of trades carried out with some orders in certain circumstances remaining unexecuted and on their order books for up to a year.

We are already seeing organisations like the LSE reducing tick sizes in liquid stocks and this will only serve to increase liquidity; and increased trades means increased orders. Such environments may well mean that Market Makers are less inclined to take positions in such transparent markets as it drives down their spreads and so the obligation to post unfilled orders may drive dealers to explore opportunities in upstairs trading (ie dark pools) – away from the exchanges and perhaps even regulatory scrutiny.

This article in no way suggests that dealers would actively look to break the law but in a transparent market, given all that has been said, it is obvious that market makers will look to protect their profits. Again algorithms are increasingly being used to sweep pools of darker liquidity and this continuing trend is likely to present one of the most complicated propositions for regulators. Put simply how on earth are they going to monitor this activity? There are approximately 12,000 listed securities in Europe and 2,300,000 trades per day³. And that is merely the trades. If orders are more than 3 times that of trades and the gap grows as expected the number of unfilled orders is going to accelerate to unprecedented levels.

It will be hard enough for the FSA, let alone some of the smaller competent authorities who have far less IT budget available to effectively police the situation and if firms look to be creative with their interpretation of MiFID it simply makes the situation more complex. MiFID's Article 22(2) is not exactly clear about where or how SIs should publish – they must “take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants”. In an era where borders are opening across the EEA, if we are not careful treating market entrants equally will drive the industry towards the lowest common ‘technology’ denominator - the disparity between rich and poor nations in Europe, especially in capital markets terms, is stark and what is “easily accessible” to one European market participant is not necessarily easily accessible to another. Furthermore, Article 31 of the Regulation indicates SIs must publish to an RM or MTF but it doesn't state in which EU country and what effective communication they must have and in any event that is unless the “client expressly instructs otherwise”.

Traders are driven by success based on profit and in order to achieve that they have significant budgets to draw on – much more than regulators. As “necessity is the mother of invention”, profit is absolute necessity to traders who are innovative and creative when it

³ Data from the Federation of Securities Exchanges (FESE) web site

comes to finding ways around regulatory barriers. So, rather like a Formula 1 team as new rules are put in place to slow the cars each year the team spends time, effort and money trying to improve around the regulation. There are more rules in Formula 1 than ever before yet the cars continue to go faster. MiFID, far from increasing transparency may drive more trading in dark pools and lead to innovation in technology that no one has yet anticipated.

5. Conclusion

It should not be underestimated how much business RSPs and soon to be SIs carry out away from exchange order books on a bilateral or negotiated basis. This type of business is fundamental to the market. It is driven by a desire to reduce fees and increase profitability and it is believed that such OTC business currently accounts for an estimated 50% of trading. It is a growth area in equities and allows RSPs and market makers to manage risk, attract business and offer trading terms that reflect the type and size of the order. Additionally, OTC trading allows them to offer price improvement, something that MiFID is not in favour of to retail clients (although they can provide price improvement to professional clients in certain circumstances).

Post-MiFID, OTC limit orders will need to be made public and as demonstrated above this could mean an increase in cost, a reduction in the desire for Market Makers to take risk based positions and actually a return to some form of concentration – actually reducing competitiveness.

As Theresa Villiers, MP and former European Parliament Rapporteur on MiFID, said in 2003:

“The Commission’s proposal would damage many investors, not protect them. Diverting orders to regulated markets will drive up costs and can prevent best execution from being obtained. Revealing client orders could cause markets to move against them, making trade execution more difficult and pushing liquidity outside the EU”.

The last point is absolutely critical. There is a very real chance that the obligation to publish unexecuted limit orders will mean that the cost reductions, the anonymity and the execution strategy afforded by current OTC activity will be lost under MiFID. If that is the case traders will not simply accept the status quo of having to pay to publish their orders to a venue, they will search elsewhere for similar higher margin trading either in Europe or not. The only way that this may not happen is through the success of agile and cost-effective execution venues who are on the execution lists of the main SIs. Market Makers’ ability to quantify risk in fast moving markets or in highly liquid shares becomes less certain and so they will have to know that the venue can handle high speed instructions and a certainty in order filling.

These venues will have to offer value-add services to increase attractiveness but also low fees and fast communication through low latency connections. This is exactly the sort of thing Equiduct, Chi-x and Turquoise are positioning themselves to offer but set against the size and strength of the old bastions of the market like the LSE and Deutsche Börse, their success is not yet guaranteed. If they fail one has to ask whether MiFID will bring greater competition driving down costs or in fact it will be seen as regulatory inertia and become a catalyst to departing capital.



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