James Hilton

Head of Advanced Execution Sales EMEA, Credit Suisse

Sharpening the focus on investor outcomes

Regulators agree the greatest drag on investor returns is driven by costs. MiFID I was the EU's attempt to create a single financial market to rival the depth and dynamism of US capital markets. It reduced costs to end investors by increasing competition and breaking down monopolies. MiFID II's objectives of investor protection and a safer, more transparent and efficient market appear to have been interpreted in a way that risks increasing costs to investors.

Costs can be explicit, e.g. exchange fees or investment management charges, or implicit, such as market impact, information leakage or opportunity cost. Post MiFID I, we saw a 30% decrease in total transaction costs – a huge success for investors. Unsurprisingly, explicit costs are often driven by competition amongst providers. Around the start of MiFID II, we observed a swathe of price increases amongst primary exchanges as regulation appeared to force trading to lit venues. It is important regulators are aware that policies promoting champions will likely lead to inefficiency, lack of innovation and higher costs as competition reduces.

One-way investors minimize implicit costs is by choosing between different trading modes. Investors have long understood the trade-off between urgency and market impact and sought to find the right balance to fulfil best execution. We see no evidence these choices, and the natural balancing of these factors, have impacted market stability or efficiency over the last decade.

Under MiFID II, the industry has innovated to find solutions which meet all regulatory requirements and also provide best outcomes for end investors. Periodic auctions in particular enable investors to seek liquidity without excess price impact, whilst still maintaining pre-trade transparency. Based on ESMA's Call for Evidence, investors and brokers alike seem to be hugely supportive of this innovation.

Costs are also reduced when a fair price can be achieved. The midpoint is a fair price and is undoubtedly beneficial to end investors across a variety of trading modes. Allowing mid executions does not cause tick size wars between venues or trading modes, nor trades in fractions of a tick, but provides an equitable price without arbitrarily picking winners and losers – penalizing end investors to give the perception of a level playing field between trading modes is surely not the goal of MiFID II.

It is the end investor who bears the costs of choosing champions or prohibiting innovative trading modalities. Central Limit Order Books provide an important service to financial markets but are not always the best solution either at a collective or an individual level. A variety of trading modalities solves for different investor needs without detracting from price formation. In summary, the framework of MiFID II is broadly effective, and therefore a wholesale revision should be avoided. Some fine-tuning would make sense, however, to address some of the issues raised in this article, and we would encourage consideration of the following in particular; calibration of thresholds post-Brexit, additional transaction costs passed to investors, and the share trading obligation. As noted, such targeted amendments must avoid damaging best execution for end investors. ●