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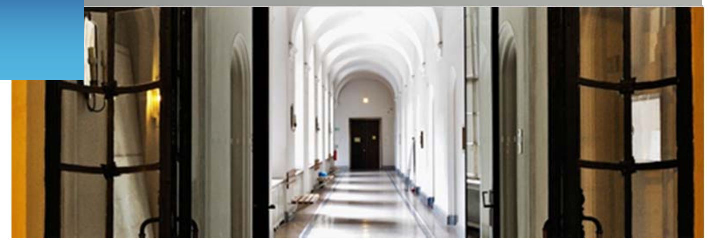
ViewPoint

June 2011

Equity Market Trading in Europe:
The Case for Refinement Over Revolution



Three years after its implementation, the cornerstone of financial market regulation in the EU - the Markets in Financial Instruments Directive (MiFID) - is under review. Financial markets have changed and technology has evolved meaningfully since 2007. In the aftermath of the global financial crisis of 2008 and 2009, regulators worldwide have declared vigilance in their efforts to ensure market transparency and investor protection. The MiFID Review represents both the updating and reconfiguration of legislation governing Europe's financial markets.

As such, the European Commission, after welcoming responses to their review on MiFID last year, is currently evaluating proposals to improve the regulatory framework, enhance transparency and strengthen investor protection. The European Commission is expected to adopt formal amendments to MiFID by October 2011. As a fiduciary for our clients, BlackRock has a strong interest in competitive and efficient markets and a regulatory regime that encourages liquidity, transparency and price discovery.

In this *ViewPoint*, we focus specifically on the global policy discussions pertinent to today's equity market landscape in Europe. We believe trends in equity market trading since the 2007 adoption of MiFID have allowed investment managers to deliver improved investment performance, enabling them to better fulfill their fiduciary duties to investors. With this in mind, we argue for refinement rather than revolution of the existing regime. We encourage regulators to consider enhancements to existing regulations that address legitimate concerns without discouraging innovation and progress.

European Equity Markets: Background

European equity markets have developed significantly since the advent of electronic trading over two decades ago, in terms of both the variety of execution venues and manner in which equities can trade. Electronic order books have matured and systems have become increasingly more efficient and appealing to investors.

Even as the European equity markets have evolved, a few aspects remained constant such as the incumbent exchange's responsibility for listing, secondary market trading, trade reporting and market surveillance. The market remained this way until MiFID came into force on 1 November 2007 across the European Economic Area (EEA).

MiFID was introduced primarily to increase competition within investment services in Europe. MiFID helped support the rise of alternative trading venues, most commonly referred to as Multilateral Trading Facilities (MTFs) as evidenced in the graph on the following page. As a result, the liquidity of a given stock was no longer concentrated on one exchange. Rather, liquidity became spread across a growing number of trade-execution venues, increasing competition for orders between these various "pools" of liquidity.

BlackRock believes the equity trading environment in Europe today generally serves investors well and, further believes, in the context of the forthcoming MiFID Review that:

- High-frequency traders provide a vital service to all market participants.
- So-called "dark pool" trading allows large institutional clients, such as pension funds, to place orders without distorting the market.
- Trade reporting of large orders is deferred to minimise market distortion.
- Where they exist, consolidated tapes paint a more complete picture of a given security's liquidity across venues.

As reforms are considered, we believe equity investors would be best served by a targeted and limited adaptation of the regulatory framework rather than a radical overhaul. History continues to be written. Policymakers today should take account of benefits and potential risks of any new measures around equity trading. In the following, we offer thoughts and recommendations on aspects of the MiFID review as it relates to Europe's equity trading environment. The issues are set out in order to reflect the key issues from trading to reporting.

High-Frequency Trading in Europe

High-frequency trading (HFT) is generally regarded as the execution of computerised trading strategies characterised by brief position-holding periods. In high-frequency trading, programs analyse market data to capture trading opportunities that may be open for only a fraction of a second to several hours. High-frequency traders compete on a basis of speed with

Milestones in the Global Evolution of Equity Trading

1971: The world's first electronic stock market, the National Association of Securities Dealers Automated Quotations (NASDAQ) exchange, was formed in the United States.

1986: The London market undergoes a process of de-regulation commonly referred to as the "Big Bang." Minimum scales of commission were abolished and trading shifted from face-to-face to an electronic market conducted in separate dealing rooms. Firms could now also act in both broker and dealer capacities.

1991: In Germany, a form of electronic trading was possible when the Frankfurt Stock Exchange introduced an integrated trading and information system.

1996: The Investment Services Directive entered into force allowing European banks access to the market. These laws also relieved intermediaries of the obligation to trade through the market in the jurisdiction in which they were located. Exchanges for the first time were free to establish a Europe-wide network, such as that witnessed by the Paris Bourse, which today is part of the New York Stock Exchange (NYSE) Euronext global network of exchanges.

other high-frequency traders, not long-term investors (who typically look for opportunities over a period of months or years), and compete with each other for very small, consistent profits.

High-frequency traders employ a plethora of different strategies, but their first and core strategy remains market making. Similar to the function of pre-Big Bang / pre-MiFID market-makers (see milestones above), high-frequency traders provide liquidity by buying and selling the same stock with the objective of earning a spread. Regardless of the venue – whether an open trading floor or as a high-frequency trader – market makers provide investors with the liquidity necessary to transact in the markets. In short, HFT helps to create efficient markets by facilitating price formation, lowering the cost of trading and improving the linkage between markets. All of this, in turn, aids in achieving optimal investment performance for end investors.

Some fear that HFT increases volatility in turbulent declining markets and could result in a "flash crash" such as that experienced in the US in May 2010. Safeguards and reforms that have been implemented will help slow down a potential future market disruption. For additional background on the Flash Crash and an update on market reforms since, see *Revisiting the Flash Crash: A Year has Passed, What Has Changed?* at http://www2.blackrock.com/global/home/PublicPolicy/index.htm.

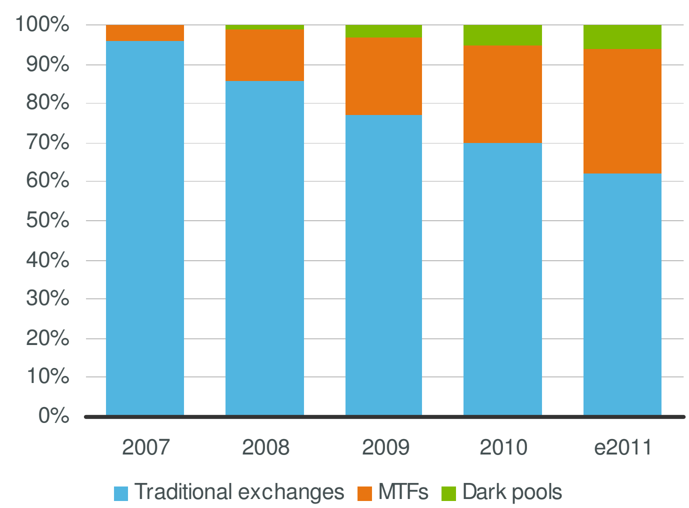
Recommendations for High-Frequency Trading in the MiFID Review

- BlackRock would support a broad definition for automated trading with HFT being a subcategory thereof.
- We disagree, however, with the Commission's proposal that high-frequency traders, if they cross a quantitative threshold, be authorised as investment firms.
- Rather, we believe the definition should apply across the board. The regulatory requirements of capital, organisational and risk management should capture all players to ensure a more robust regulatory environment.
- We strongly support requirements for automated trading firms to have robust control systems, to notify their algorithms to supervisors, and for trading venues to be outfitted with circuit breakers (for exceptional circumstances) and other risk controls.
- However, requiring high-frequency traders to provide liquidity on a continuous basis would be detrimental to investors in the long run due to the implicit additional cost to trading this change would herald.
- Likewise, we believe that the introduction of minimum resting periods (on an ongoing basis) for orders before they can be cancelled from the order book introduces inefficiency into the market for little discernable benefit.

"Dark" Pools and "Lit" Markets

"Dark pools" are venues, like exchange order books, but where the bids and offers cannot be seen. Dark pools are run by independent operators, broker-dealers and exchanges and are utilised primarily by institutional participants for the purpose of executing large blocks of stock in a manner which minimises the potential of impacting the stock price. Currently "dark liquidity" is a small fraction of the total volume of electronic trading.

Evolution of alternative venue adoption in Europe, 2007-e2011 (percentage of average daily trade value)

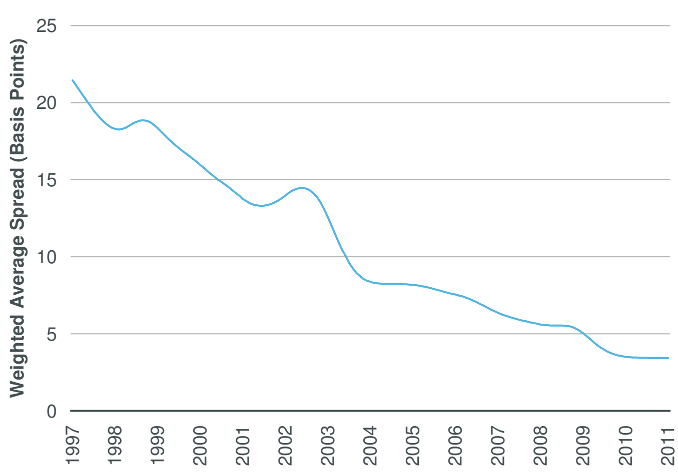


Source: Aite Group

In contrast, investors on a "lit" market can see the number of bids, offers and the number of shares they are good for. Market makers, such as high-frequency traders, will post bids and offers across many order books, angling for a market participant on one venue to buy (from them) and another to sell (to them) on a different venue. Given the structure, it is conceivable that a given market maker might buy and sell at the same price, but the relevant market will pay them for one or both trades for posting liquidity. Thus, revenue is not always achieved by buying lower than the selling price, but merely by being paid by both venues.

If an institutional participant focuses its trading on the "lit order books," interacting initially and primarily with a market maker, that institution runs the risk that prices will start to move against its position. What if large investors could post their position where other market participants could not see it, with the hopes that another participant with opposing stock views might come and post their position too? This, in effect, is a so-called "dark pool," which enables participants to seek liquidity while reducing the risk of distorting stock prices. It is unfortunate that this term has taken on such a pejorative meaning in the industry lexicon; we believe the dark pool market structure has, in fact, brought discernable benefit for investors. We have also noted that spreads in Europe have consistently tightened, indicating that – there is no evidence to support that dark pools hinder price discovery.

FTSE 100 Spread



BlackRock believes that increased market efficiency is the overriding benefit of "in the dark" order-matching. Trading in "dark pools" helps reduce the market impact of sizable orders typically placed by large institutional clients, such as pension funds.

Recommendations for "Dark Pool" Trading

- BlackRock would support the introduction of a new definition of "Organised Trading Facility" (OTF) to cover all trading that is not executed on regulated markets, Multilateral Trading Facilities (MTFs) or through systematic internalisation.
- The thresholds to demarcate this category should be set at appropriately high levels so as not to impair liquidity creation in OTFs.
- We further recommend that the European Commission clarifies "systematic internalisation." The goal should be to close current gaps by revisiting and/or expanding definitions (by, for example, bringing forward principles in this area).

Deferred Publication

Following the financial crisis in 2008, regulators around the world have responded to calls for new regulations designed to champion investor protection and bolster financial stability. This, however, is an extremely complicated endeavor which could lead to unintended negative consequences for end investors. For example, investor protection and financial stability within equity markets do not always neatly correlate to a blanket tightening of reporting requirements. We believe investors and liquidity are best protected by, among other things, an appropriately tailored deferred publication regime.

MiFID requires a firm to make public specified information about transactions in shares admitted to trading on a regulated market outside a regulated market or MTF. Typically this must be done within three minutes of the transaction taking place. However, for very large trades, deferred publication is permitted. Deferred publication protects firms that take on large institutional orders – and, therefore, the end clients of those firms, such as pension funds – from having to report details of a large trade before they have had an opportunity to lay off their risk.

As part of the current consultation, the European Commission is re-examining the appropriateness of the deferred trade reporting regime for the equity markets.

Recommendations for Deferred Publication

- BlackRock believes that the European Commission's post-trade reporting proposals are generally feasible.
- However, the impact of their implementation will not reduce costs to investors and, more likely, will lead to an increase in costs in many cases, and therefore reduce performance.
- In our view, the current MiFID post-trade reporting regime serves investors well and we would therefore argue against tightening and changing such regime.

Case in Point:
How Deferred Publication Benefits End Investors

A pension fund manager conducts due diligence on a company and concludes that it would like to gain exposure to this company's equity. The manager may be interested in purchasing a substantial proportion of the available equity. Standard dealing practices would require the pension fund manager to send this order to a broker to execute on its behalf. Such an order may well take considerable time to complete, as the broker is constrained by the amount of liquidity that is available at any given time.

An alternative method of gaining exposure to the company stock would be to call a broker and ask at what price he/she would be willing to sell a block of shares. The broker, acting in a market making capacity in this scenario and understanding the dynamics of market impact and risk, would like to sell the shares at a price higher than the prevailing price. The prevailing market price, in turn, would gravitate toward this negotiated price for two simple reasons:

1. The broker who has sold the stock to the pension fund manager needs to buy the stock back, thereby incurring market impact; and
2. When other market participants see the trade report at a price above the prevailing price, other buyers will be naturally inclined to speed up and sellers to slow down, thereby driving the price upward.

Currently, when trades of this nature are conducted, the broker has the ability to delay reporting the trade for a finite period in an effort to offset this risk in the intervening period. Tightening the deferred public regime would largely remove this opportunity to delay the trade report. As a result, market makers will rationally be inclined to deal at wider spreads with the knowledge that the imminent trade report will instigate this natural gravitation of price, thereby reducing their ability to offset risk. The only loser in this scenario is the pension fund manager, who has reduced flexibility in how it gains exposure to stocks on behalf of clients.

Consolidated Tape

While investor protection would be undermined by tightening the deferred publication regime, a measure included in the MiFID review, investors in Europe continue to be disadvantaged by the absence of a pan-European consolidated tape.

Consolidated tapes are electronic systems that allow for the real-time transmission of trade prices and volume for all stocks currently listed on various exchanges. These are very common, especially in the US, where ticker tapes continually report the activity of securities that are listed on the NYSE and any of the regional stock exchanges that participate in the exchange. The same system is employed by American Stock Exchange (AMEX), reporting both the securities traded on AMEX proper, as well as any other participating markets and exchanges. The combined detail can often prove very helpful for investors with varied investments.

The sources of the data contained on a consolidated tape can come from various securities exchanges, market centres, electronic communications networks, and even from third-party brokers or dealers. In general, the level of detail is comprehensive and may include a wide range of securities and investment types. The structure of the information reported on a consolidated tape is no more difficult to understand than reading the performance ratings found in the financial section of a daily newspaper. In contrast to the information contained in the newspaper, however, a consolidated tape offers the most current information available, with prices disclosed throughout the trading day.

> Institutional investors currently finds it is difficult to answer two simple questions in relation to European equity: What is the price of a stock? And how many shares have been traded?

MiFID abolished the concentration rule (routing orders through national incumbent exchanges), causing liquidity pools in Europe to become fragmented. The European Commission is now considering how the introduction of a mandatory consolidated tape could be implemented and is evaluating three options for the establishment and organisation of such a tape. A pan-European consolidated tape would clearly benefit investment

The Case for Consolidated Tape

Consider this scenario: The bid price – the price an investor is willing to pay for a stock – is 90 cents, but the offer price is 110 cents. How is it possible to determine the price of the stock?

Based on this information alone, the market would likely prescribe a price of 100 cents, the mid price. However, additional information might change the scenario. For example, perhaps the last trade reported for the stock occurred at 110 cents. Some might still suggest the mid price of the bid and offer while others might consider the last traded price of 110 as the appropriate valuation for the stock in question.

Suppose this stock trades across several central limit order books. Is "the price" the mid price of all order books aggregated together, or is it the last traded price on the primary market, or the last traded price wherever it occurred, or is it simply the last price reported, whether it was on an order book or, for example, in a dark pool?

"What is the price of a stock" is a fundamental question that currently is not easily answerable in Europe. Another fundamental question that is even more difficult to answer is, "How many shares, in total, traded?" The solution? Some form of consolidated tape which would provide a comprehensive summary and history of a stock's trading activity.

BlackRock supports regulatory reform that serves to increase transparency, protect investors, facilitate responsible growth of capital markets and preserve investor choice.

managers and end investors. By acquiring the "full view" of market activity, investment managers would be able to make better informed investment decisions on behalf of their clients, thereby increasing the potential to achieve optimal investment performance.

Recommendations for Consolidated Tape

- BlackRock believes it is now time to introduce a pan-European consolidated tape to reconcile reporting from the various exchanges and data service providers.
- This would greatly help investors get a more complete picture of a security's liquidity across venues, protecting investors and attracting further liquidity for better-informed investment decisions.
- BlackRock believes that a mandatory solution will bring about the required changes. Without concerted efforts to define common standards, the competitive solution is unlikely to satisfy end users' requirements.

Conclusion

Equity trading in Europe remains dynamic, with continued innovation driven by the possibilities of increasingly efficient technology. We believe it is an integral part of our fiduciary duty to clearly articulate the investor's perspective with the goal of achieving an optimal regulatory framework. An optimal framework, we believe, appropriately protects investors whilst fostering an environment of best execution and technological innovation.

In our view, today's globalised equity markets generally serve end investors well. It is incumbent upon policymakers to ensure, during the current intense period of regulatory scrutiny and reform, that a real choice of appropriately regulated execution venues remains available for investors in the future. Policy choices taken today should facilitate infrastructure consolidation, liquidity dispersion and improved efficiency. This ultimately should promote market transparency and lower costs for end investors.

For related material on financial regulation in the EU, see *Regulatory Developments in Europe: An Overview and Analysis* at http://www2.blackrock.com/global/home/PublicPolicy/index.htm.

About BlackRock

BlackRock is one of the world's leading asset management firms. We manage over €2.6 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. We do not enter into proprietary business nor do we act as principal.

Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals around the world. BlackRock represents the interests of its clients by acting in every case as fiduciary. It is from this perspective that we engage on all matters of public policy.

BlackRock is also a risk manager and has advised on a significant number of high profile and complex mandates following the 2008 financial crisis. As such, BlackRock is committed, and has made a strong contribution, to the restoration of financial stability in Europe and worldwide.

BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice.

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