

MiFID

Capital Decapitalised

October 2007



Markets in Financial Instruments Directive (MiFID)

MiFID, which becomes law on 1 November 2007, will structurally alter the trading mechanism of European equity markets. For the first time brokers will not have to trade through the established exchanges, but will be able to access so-called 'dark pools' of liquidity in order to execute their business. The directive, which is designed to harness advances in technology to increasingly complex trading strategies and global demand, will remove the European exchanges monopoly protection and require brokers to:

- > Offer Best Execution on criteria including price, speed, liquidity, risk and settlement
- > Monitor the effectiveness of execution
- > Report all trades in EU listed securities to the appropriate authority
- > Retain all trade data for five years

Redburn Partners will:

- > Use 'smart order routing' to access multiple sources of liquidity and reduce costs
- > Assimilate all relevant data for trading through purpose-built Royal Blue Fidessa infrastructure
- > Monitor execution quality through external consultants' analysis
- > Continue to offer bespoke execution entirely free of internal or external conflict

For execution, Redburn Partners has been:

- > Ranked 4th globally out of 2,000 brokers for 'Cost of Execution' by Institutional Investor (2006)
- > Ranked in the top 5% of European brokers by consultants Abel Noser (2007)
- > Ranked 8th for UK Agency Business (volume) by the LSE (2007)

It is likely the fragmentation of the market will lead to increased competition, greater efficiency, reduced cost and less visible market impact for traders. It will also reduce the need for brokers to use their own capital in order to facilitate execution. The primary beneficiaries will therefore be independent agency brokers and asset managers, who from 1 November will have a wider range of counterparties with whom to deal.

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Introduction

The Markets in Financial Instruments Directive is probably the greatest single change undertaken by European equity markets. It endeavours to utilise modern technology to satisfy complex trading strategies and global demand and it will liberalise equity trading. The new law removes the European exchanges' protection, allows agency brokers and investment banks to trade beyond the established exchanges in the so-called 'dark pools' of liquidity, but requires they guarantee best execution. The directive also imposes a significant organisational and technological burden upon all participants, in order that information flow and execution quality may be closely monitored.

Obligations

Brokers must achieve best execution on behalf of their clients on broader criteria than simply price. In future, factors such as speed, risk, liquidity, market footprint and quality of settlement will also be calibrated. Moreover, brokers must agree an execution policy with their clients and continually monitor the effectiveness of that policy, in addition to reviewing their *modus operandi* annually. They must report all trades to the appropriate authority in a timely manner and retain trade data for five years.

Execution

Brokers have no obligation to deal through the traditional Exchanges, but must deal wherever they can deliver best execution. This allows them to access the most appropriate venue, which may be one of the 'dark pools' of liquidity outside the traditional Exchanges. The choice of trading venue will allow a choice of reporting venue, which will also enhance the cost effectiveness of trading. The inevitable breakdown of the Exchanges' monopoly is expected to lead to greater competition, lower dealing costs and, critically, reduced market impact which (rather than commission) is the real if invisible cost of trading. It will also ensure the market becomes more fragmented and execution more complex, so that establishing the 'right' price for a trade, or even VWAP, will become more challenging.

Execution Policy

Our policy is to provide best execution for all orders taking into account price, size, cost, liquidity, timing, risk, likelihood of execution, market impact, ease of settlement and any other consideration material to the optimal execution of the order in question.

Post Trade Analytics

Redburn has monitored its execution efficiency for over two years and has been ranked 4th globally by Institutional Investor for the quality of its service. We also employ the consultants Abel Noser to undertake regular empirical analysis on our behalf. The new legislation enforces such analysis on all market participants.

Redburn

As an agency broker Redburn will select trading venues solely on the basis of its best execution policy. We will not be under pressure to provide liquidity to a self interested trading venue, and will not suffer the conflicts of owning alternative trading platforms, running proprietary trading books or making markets. Through our 'smart order router' we can execute trades anywhere, compelled only by the requirement of best execution. Royal Blue Fidessa has built the infrastructure to enable Redburn to execute with maximum efficiency and access all the necessary data, ensuring we fulfil all our obligations under MiFID.

Opportunity

All change creates opportunity, and in this instance the playing field is tilting towards lighter-footed, agency brokers. This is because the fragmentation of the market, which will probably occur more rapidly than many expect, reduces the need for firms to place their own capital at risk in order to facilitate trades. And, as the *need* for capital in trading declines, so the *value* of capital in trading declines. This undermines the historic competitive advantage of the deep-pocketed but often conflicted investment banks and is to the advantage of both agency brokers, who will no longer suffer from a lack of capital, and asset managers, who will have a wider range of brokers with whom to trade. As a result the old certainties and affiliations will be dismantled and the efficiency of the market increase, even as the cost declines.

Trading Platform Post MiFID

