The Spanish Securities Market under the Markets in Financial Instruments Directive

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Abstract

The integration of the European capital markets has been an ongoing priority for the European Commission since the Euro was introduced in 1999, with policies aimed at integrating the financial markets of the EU Member States. Of all the European Union rules resulting from the Financial Services Action Plan (FSAP) in the last years, the Markets in Financial Instruments Directive (MIFID) is probably the one with the highest impact. For markets and financial intermediaries, the MIFID involves highly relevant changes in the operation and organization of their activities. The new regulation brings business opportunities and permits the development of new products and services.

The MIFID transforms financial services markets at all levels, from the trading of securities to the way in which financial intermediaries interact with their clients. In short, the creation of a uniform market for instruments, suppliers and financial services brings new opportunities until now hardly imaginable in the financial industry.

The entry into force of the new Markets in Financial Instruments Directive (MIFID), as argued above, results in the creation of a new financial market environment focused on fostering competition on equal terms, with the final purpose of creating an efficient single financial market in Europe. One of the most relevant issues in this new framework is the definition of liquid shares, which is also critical in the creation of an efficient market. The liquidity of shares in financial markets is an issue of most importance for investors, because at a given point in time, investors prefer to invest in securities that can be more easily placed on the Market, and also because the quality of an equity exchange, understood as the efficient price configuration of the shares listed therein, is determined by liquidity.

The preference for liquidity sets an important guideline in hierarchy a given series of securities. Traditionally, the Frequency Rate and the Trading Volume or Turnover Rate can be mentioned as the indicators providing us with information on the possibility of buying or selling a security on a given day. The first rate is associated with the statistical concept of frequency. For a selected sample space of trading days, the concept of frequency can be replaced with that of the probability that a given security is traded on a given trading day. The Frequency Rate and shows the existing relation between the nominal capital and the firm's capital admitted to trading.

Introduction

In the particular case of the Spanish securities market, the transposition of the EU Directive into the national law has materialized in the amendment of Spanish Act 24/1988 governing the Securities Market. The recently approved amendment of the Securities Market Act is based on four cardinal principles:

- The modernization of the Spanish securities markets to adapt them to current needs. To address these new needs, the Act enlarges the catalogue of investment services that can be provided by financial institutions, it extends the range of marketable financial instruments and acknowledges the applicability of different systems or methods for the execution of transactions on financial instruments.

- The reinforcement of the measures envisaged to protect investors. Thus, the Act sets forth a wide range of rules to be abided by investment service providers.

- The adaptation of the organization requirements to be met by investment service institutions to ensure they fit the complex range of services they provide.

- The enhancement of the supervisory powers of the Spanish securities market agency, CNMV (*Comisión Nacional del Mercado de Valores*), which includes the development of the necessary instruments and mechanisms to foster national and international cooperation between supervisors.

Our contribution focuses on the first principle, in particular on the new legal and trading environment for markets. To this respect, the new securities trading environment is basically characterized by the existence of new competing trading systems: Regulated Markets (RM), Multilateral Trading Facilities (MTF) and Investment Firms (IF), which carry out systematic internalisation of transactions. In addition, the new scenario removes the concentration rule and ensures freedom of choice as regards the clearing and settlement facility.

Discussion

Once we have defined our focus in this paper on the new trading environment, we will now provide a description of the new securities market scenario, which will be followed by a revision of the concept of liquid shares developed by the MIFID and of its actual implementation.

For the purposes of fostering transparent, equitable and efficient financial markets supported by trading and execution rules that are applicable both to markets and to intermediaries, the MIFID acknowledges regulated markets as the markets “par excellence”, i.e. as the most efficient markets, and sets forth the need to establish stringent authorization requirements not only for regulated markets but also for their operators. In particular, the MIFID refers to organization and supervision requirements, requirements concerning membership and admission of securities to trading, and freedom of choice as regards the clearing and settlement facility.

In the transposition of the Directive into the Spanish Act, Spanish regulated markets are referred to as secondary official markets, as they were named in the 1988 Act, and are defined as "multilateral trading systems which facilitate the bringing together of multiple third-party buying and selling interests in financial instruments in a way that results in a contract, in respect of the financial instruments admitted to trading, and which are authorised and function regularly and in accordance with the provisions of the law". The Act also sets forth that the legal framework for secondary official markets shall be completed with the Market Regulation to be authorized by the Spanish Minister for the Treasury.

The Multilateral Trading Facilities (MTFs as defined by the MIFID) is another new trading system. This is also multilateral systems operated by an investment firm or a market operator, which bring 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 operated by an investment firm or a market operator. Contrary to regulated markets, they do not have public functions (e.g. suspension of securities).

MTFs shall establish transparent, non-discretionary trading rules, and market operators operating a MTF shall establish and maintain effective arrangements and procedures for the regular monitoring of the compliance by its users with its rules. In addition, they shall monitor the transactions undertaken by their users in order to identify breaches of those rules or conducts that may involve market abuse, and shall inform the competent authority both of their rules and of any circumstances that may involve market abuse.

One of the prudential measures established by the MIFID on MTFs refers to the ability of investment firms to operate them and, as simultaneous providers of investment services, to incur possible conflicts of interest. We should stress that, in the new MIFID environment, investment firms are authorized to manage orders on own account and on behalf of clients, to receive and transmit orders and to operate an MTF.

The table below reveals that MTFs in Spain have remained unchanged for the two analysed periods (the date of entry into force of the MIFID and July 15, 2008): Sistema Español de Negociación de Activos Financieros, MTS Spain SA, Latibex and MAB.

Table I. Multilateral Trading Facilities

	11/01/07	**07/15/08**
Spain	4	4
Rest Of Europe	84	118

Source: Own work

In the European Union as a whole, during the same considered periods, multilateral trading facilities grew from 84 to 118, i.e. a growth rate of over 40%.

The term systematic internaliser refers to the investment firms which, in an organised, frequent and systematic basis, deal on own account by executing client orders outside a regulated market or an MTF. Two basic ideas can be drawn from this definition:

- A systematic internaliser competes against the other trading systems (regulated markets and MTFs), which makes it necessary to establish an equitable transparency framework. The MIFID requires this agent to comply with a series of obligations regarding the maintenance of prices and the updating and withdrawal of quotes.

- The difference between a systematic internaliser on the one hand and regulated markets and MTFs on the other lies in the fact that the systematic internaliser, in dealing on own account, risks its own capital, which adds risks to its transactions that are offset with different transparency requirements.

The MIFID, in short, creates a fragmented system, in which orders may be routed to the regulated market or to a multilateral facility, or may be matched directly on own account by investment firms. Actually, the interaction of all the involved agents is also possible. Following the MIFID provisions, for instance, an order may be placed on a systematic internaliser, which in turn can route it for execution by an MTF or a regulated market. The complexity of the new environment poses challenges and requirements but also opportunities for all market participants. As regards issuers, the MIFID aims at facilitating their access to markets and, as a consequence, to new funding sources. Markets and investment firms will be faced with more competitors, but at the same time will have new business opportunities. Competent authorities, finally, will have to address new supervisory challenges.

The table below shows the evolution of systematic internalisers only at a European level, since no such agent is operating in Spain yet. As regards the European Union, the figures reveal an increase in the number of existing systematic internalisers between the two analysed dates, from four systematic internalisers in November 1, 2007 to eleven in July 15, 2008, an increase rate of 36%.

Table II. Systematic Internalisers

	11/01/07	**07/15/08**
Spain	0	0
Rest Of Europe	4	11

Source: Own source

The MIFID places great importance on the trading environment for Continental equity. This new environment reduces the distances between markets and investment firms, which may operate a market or “become markets themselves”. The stated purpose is fostering transparent, equitable and efficient financial markets supported by trading and execution rules that are applicable both to markets and to intermediaries.

The consequences, and at the same time challenges of the new trading environment, therefore, shall be as follows:

- Fragmented trading: All the transactions flowing across the different trading facilities shall need to be consolidated at a given point to ensure Best Execution of orders.
- An appropriate transparency framework shall be established. It should be an equitable, fair and reasonable framework, which ensures that both markets and market participants receive the adequate information.

- Best Execution of orders shall be regulated.
- Supervisory authorities are faced with the challenge of managing the communication of transactions.

Methodology

The Committee of European Securities Regulators (CESR) compiles the information submitted by National Regulators on liquid shares and enters it into a public database it keeps updated. Liquid securities are divided into "classes" based on the average transaction size. These classes are then used to calculate the Standard Market Size or SMS; the size of the order is relevant because it involves a series of transparency obligations for systematic internalizers.

In our practical application, we intend to analyse the evolution in the level of liquid shares of the Spanish securities market within the European context. The data used for the study were collected from the database of the CESR. In effect, the MIFID implementing Regulation (No. 1287/2006, of August 10, 2006) requires the relevant competent authorities to calculate and publish a set of information regarding all shares that are admitted to trading on a regulated market. CESR collects this information, and publishes it in the form of a database. The information included in this database allows market participants to recognise liquid shares, while providing also other data that are indispensable to get an understanding of the structure, composition and evolution of the European securities markets. The analysis is performed for two different periods: November 1, 2007, date when the MIFID entered into force, and July 15, 2008, date before the financial crisis occurred. As regards the evolution of liquid shares, one of the parameters considered by the CESR to classify shares as "liquid" is the "average daily turnover", defined as the yearly turnover divided by the number of trading days. The figure is expressed in Euros. The analysis of the data enables us to state that:

- Of the 61 Spanish firms currently classified as "liquid" by the CESR, 35 belong to the group of firms comprising the Ibex 35, 17 belong to the Ibex Medium Cap and five to the Ibex Small Cap, the reference liquidity indexes for the Spanish market. The four remaining firms belong to the General Index of the Madrid Stock Exchange.
- All the firms classified as liquid have an average daily turnover of not less than 2 million Euros, thus satisfying one of the two CESR requirements to qualify for the "liquid" classification.

Table III. Average Daily Turnover

AVERAGE DAILY TURNOVER				
01-11-2007	**15-07-2008**	**01-01-2007**	**15-07-2008**	**COMPANY**
17,17%	**17,17%**	**854.732.246**	1.190.181.613	BANCO SANTANDER
16,28%	**16,36%**	**810.444.741**	1.134.020.280	TELEFONICA
14,05%	**13,11%**	**699.396.543**	908.505.796	BBVA
0,00%	**11,72%**		**812.661.978**	**IBERDROLA RENOVABLES**
9,40%	**7,12%**	**468.155.150**	493.329.783	ENDESA
5,41%	**6,05%**	**269.156.772**	419.134.852	IBERDROLA
6,65%	**4,50%**	**331.092.978**	312.176.279	REPSOL YPF
68,96%	**76,03%**			

Source: Own work from CESR data

The above table also confirms that the first seven firms on July 15, and the first six on November 1 alone, concentrate 76% and 69% respectively of the global turnover of all the liquid firms, which reveals the high level of concentration of the Spanish securities market.

The second parameter considered by the MIFID to classify a company as "liquid" is the number of daily transactions, which complements the turnover (average daily turnover in Euros) expressed in trading units. The CESR calculates this average dividing the number of annual trades by the number of trading days.

Results

The data shows that the condition regarding the minimum number of transactions is not satisfied by all firms. In fact, for the first analysed period (November 2007), 11 of the 66 liquid firms have a daily average number of transactions of less than 500, which represents 16.66% of the firms. The percentage for the current period (July 15, 2008) is 14.75%, i.e. 9 out of the 61 firms classified as liquid as of that date. However, as already explained, the classification as a liquid company is obtained only by firms with a free float of not less than 500 million Euros, but of the two other conditions (minimum average daily turnover and daily transactions) just one needs to be satisfied.

The Spanish market went from 66 to 61 liquid shares, which represent a decrease of 7.58%. The trend at the European Union level was exactly the contrary, since the number of liquid shares was 873 as of November 1, 2007 and 1,004 as of July 15, 2008, which involves an increase of 15%. On the other hand, still based on CESR data, the number of firms classified as liquid in relation to the total number of firms considered by the CESR has decreased considerably (based on this criterion) for the Spanish market. However, there are many reasons for confidence that enable us to argue that Spain, based on our analysis regarding the liquidity of Spanish firms after the entry into force of the MIFID, will be represented, as it has been in the past, in the configuration of the global future of markets from a position of competitiveness, reliability, transparency and strength.

Conclusions

The new securities trading environment is characterized by the introduction of new competing trading systems: Regulated Markets (RM), Multilateral Trading Facilities (MTFs) and Investment Firms (IF), which perform systematic internalisation of transactions. The evolution of Regulated Markets in the analysed period (November 1, 2007 to July 15, 2008) was almost inexistent both at the Spanish and at the European level. MTFs remained stable in Spain but experienced a 40% increase at the European Level, while the increase of systematic internalisers at the European level was of 36%.

The MIFID liquidity largely coincides with traditional liquidity criteria, since of the 61 Spanish firms currently classified as "liquid" by the CESR, 35 belong to the group of firms comprising the Ibex 35, 17 belong to the Ibex Medium Cap and five to the Ibex Small Cap, the reference liquidity indexes for the Spanish market. The four remaining firms belong to the General Index of the Madrid Stock Exchange.

Our analysis regarding the liquidity of Spanish firms after the entry into force of the MIFID allows us to argue that Spain will be represented in the configuration of the global future of markets from a position of competitivity, reliability, transparency and strength.

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