

## ESMA's Recommendations for MiFID II's transparency regime for equity instruments

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### Introduction

The following note is a response to the European Securities and Markets Authority ("ESMA") Final Report ("report") regarding the transparency regime for equities as part of the MiFID II review, [published on 16 July](#).

By way of an introduction, Cboe Europe is the largest truly pan-European equities exchange by market share and value traded. Through our exchanges in the Netherlands (Cboe NL) and in the UK (Cboe UK) we operate a variety of trading mechanisms (lit books, dark books, as well as a periodic auction and a large-in-scale service) for European equities trading. We also operate Europe's largest Approved Publication Arrangement (APA) for the reporting of OTC equity trades.

Since our inception in 2008, Cboe Europe has helped to promote investor choice and innovation in Europe's equity trading landscape – bringing significant benefits to all market participants, particularly end investors.

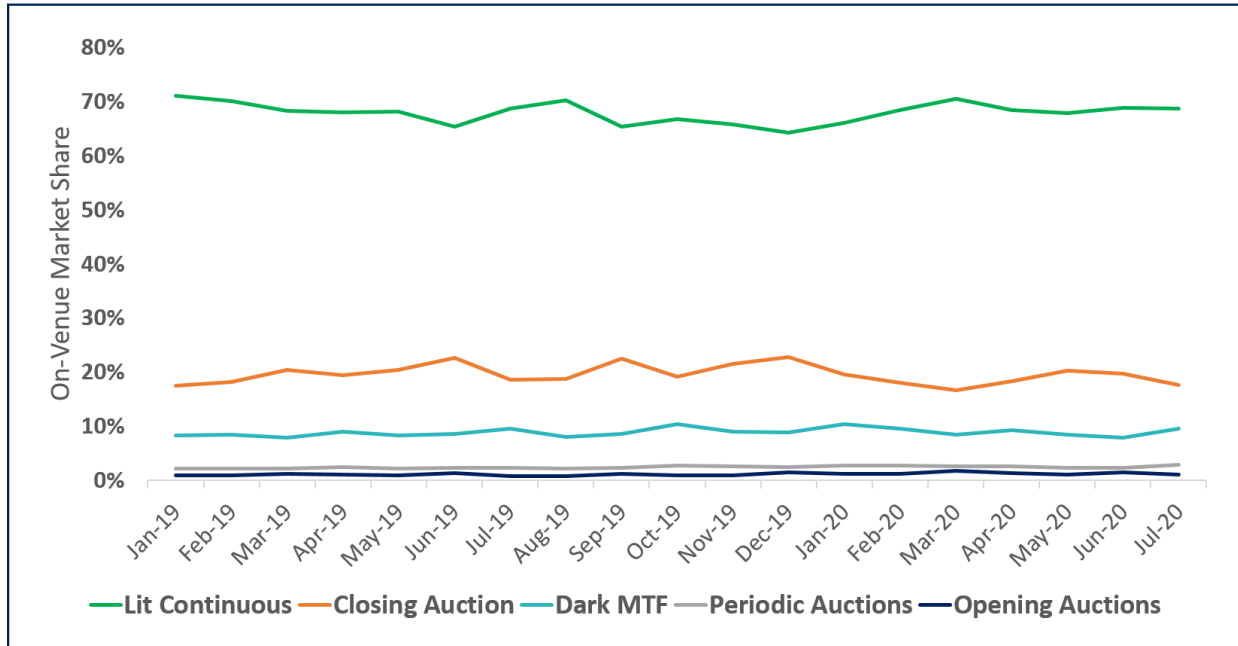
Our experience and the feedback we have received from clients points to the fact that a range of trading mechanisms is essential to meet the diverse needs of market participants, support a range of trading strategies and market conditions and make Europe an attractive global marketplace. We are concerned that some of ESMA's recommendations would undo many of the positive changes introduced over the last decade and move Europe back towards the monopolistic market structures that existed prior to MiFID I, which did not serve end investors well.

### General Remarks

Europe's equity trading industry completely remodelled at great cost to adhere to MiFID II's requirements. It is also currently contending with the challenges of the COVID-19 pandemic and the impending termination of the UK's transitional membership of the EU at the end of 2020. Against this backdrop, significant alterations to MiFID II only two years after its implementation would have to be based on evidence of harm being caused to end investors and the price formation process. No such evidence exists. Forcing trading activity onto lit markets in the hope of improving a narrow measure of transparency would increase volatility and prevent investors from gaining access to the venues actually offering price improvement combined with reduced market impact.

Recent stressed markets have showed the strength of Europe's equity market ecosystem and the benefit of having a range of execution mechanisms. During this period, the proportion of trading on lit continuous markets increased (see chart 1 below), demonstrating the ability of participants to exercise choice and use mechanisms most suited to market conditions. The increased use of these markets during this period was not because these mechanisms offered improved price discovery, as some exchanges have suggested. It is because when investors are seeking to de-lever risk in their portfolio they'll often want to do it in the fastest way possible, and using continuous lit markets, where actionable bids and offers are displayed, is a good way of satisfying this need for urgency. Many other types of market mechanisms also saw increased activity during this period.

**Chart 1 - Breakdown of On-Venue EU Equity Trading by Execution Mechanism**



**Source: Cboe Europe Equities Market Share Data**

Our other general remark is regarding ESMA’s stated aim to simplify market structure and improve transparency. These are certainly important goals – but they should be pursued with the reason markets exist in the first place in mind. That is, to allow end investors, including pension schemes, to access capital markets in an easy, secure and cost-efficient way.

In our view, as Chart 1 shows, there are no issues with levels of transparency as even during less volatile months lit continuous venues remain the pre-dominant form of on-venue trading in European equities, accounting for close to 70% of activity.

On the point of simplifying market structure, we believe the introduction of a new minimum size threshold for reference price systems would only add to levels of complexity. Furthermore, it is highly unlikely that orders prevented from being executed in reference price systems would trade on lit markets and improve transparency. Instead, OTC markets, including systematic internalisers, and closing auctions would be the likely beneficiaries, doing little to improve price discovery and increasing the systemic risk posed by closing auctions.

**Proposal to restrict use of the reference price waiver to larger orders**

Whilst ESMA’s recommendation not to completely remove the reference price and negotiated trader waivers is a recognition of the value end-investors get from those mechanisms, we do not support restricting use of the reference price waiver to orders above a certain size. This would significantly curtail a mechanism that provides genuine utility to market users.

The waiver is used to satisfy investor demand for urgent, low-impact midpoint executions, which are often the result of larger orders being broken up into smaller pieces and spread throughout the day so as not to adversely

move prices. An arbitrary minimum size would artificially constrain the ability of intermediaries to execute these orders in the most efficient way and, crucially, deny these orders the opportunity to be matched by multiple liquidity providers who may not individually be able to execute in larger size.

Not only would it be difficult to appropriately calibrate this new minimum size threshold, it would also need to be a stock-specific threshold depending on a security's average daily turnover, adding further complexity.

Part of the benefit of reference price waiver systems is that they help bridge the difference in trade size between central limit order books and the LIS thresholds, making them attractive to liquidity providers and investors alike. A minimum size threshold would limit the usefulness of the venues in this regard.

It is highly unlikely that restricting activity on reference price waiver books to larger orders only would help promote market transparency and price formation, as is ESMA's intention. Indeed, since the imposition of the DVCs in March 2018, this has demonstrably not been the case. Lit venues are often regarded by investors as venues of last resort given their high levels of market impact, so systematic internalisers (SIs) and other forms of OTC trading are likely to be the beneficiary of flow diverted from reference price systems. It is also likely that orders will instead be held until the end of the day for execution in closing auctions. None of these outcomes would be beneficial for transparency and price discovery, and would increase the systemic risk posed by closing auctions, which remain natural monopolies and single points of failure.

As ESMA highlighted in its report, removal of the reference price waiver is supported mainly by certain trading venues. Their opposition to the waiver is driven primarily by a commercial interest to restrict competition, rather than as a means to improve Europe's market structure for end-investors. It is not a proposal that has wide support among market participants, particularly end users, which are almost unanimous in their support for reference price systems.

The caps which reference price waivers adhere to under MiFID II are already costing investors real money, by denying market participants access to a venue offering price improvement and limited market impact when suspensions are in place.

Opponents of choice and competition in execution services argue that limits on reference price systems are desirable because, if left unchecked, their volumes will continue to grow at the expense of lit venues until there is no more lit trading and therefore no price formation. We believe this argument to be flawed for several reasons. First, as evidenced with alternative trading systems (ATS) in the US, there is a natural ceiling to activity on reference price systems which prevents them from reaching levels that would be damaging to price formation on primary markets. The FCA found in a 2017 study that dark trading is only damaging to price formation at a market share of over 15% - a level never reached under MiFID I nor possible under MiFID II. Use of reference price systems is a healthy indicator of confidence in the price formation that takes place on the referenced books. If lit books became so enfeebled that they were no longer useful sources of pricing data, then the reference price books would also be useless.

Second, it implies reference price trading itself has weak price-forming characteristics. This is simply not true; price formation occurs whenever buyers and sellers agree a price, irrespective of the execution channel used. Use of a reference price system is just as valid an expression of a view on price as the use of any other multilateral system. Market participants know the inputs and take a positive decision to trade there.



### **Double Volume Cap (DVC) Mechanism – Lowering the EU-wide threshold**

ESMA has said its intention is to simplify the DVC mechanism by transforming it into a single volume cap with the deletion of the trading venue threshold of 4%. It also says transparency would be improved by lowering the EU-wide threshold from 8% to 7%.

From our experience, we see little justification for either proposal. While we recognise the effort and associated cost of implementing the DVC regime, we believe the caps should be removed in their entirety rather than arbitrary alterations made to the current thresholds. There was no obvious rationale for the original 4% and 8% caps, and lowering the EU-wide threshold from 8% to 7% does not appear to be backed by any quantitative analysis.

The DVCs have introduced cost and complexity and delivered no clear benefit to execution performance and end investors. We believe there was no damage to price formation demonstrated to support their introduction and they already impose additional costs on investors seeking to achieve midpoint execution, as discussed above. Removing them would go a long way to simplifying the currently complex pre-trade transparency waiver regime for equities in Europe.

### **Frequent Batch Auctions**

Cboe Europe operates the region's largest FBA, Cboe Europe Periodic Auctions, an innovation we created in close consultation with market participants and regulators to provide an execution alternative that minimizes price impact, reduces the impact of speed by prioritising size, and allows for the possibility of price improvement. As ESMA noted in its report, both buy-side and sell-side participants have come to regard FBAs as a well-established and highly-valued trading mechanism that delivers better execution outcomes, particularly for small and mid-cap stocks. In July 2020, Cboe Europe Periodic Auctions accounted for 5.7% of all on-venue trading in FTSE 250 stocks, and 2.8% of trading in CAC Next20 stocks.

ESMA conducted a thorough and extensive consultation on FBAs last year. It received a large amount of feedback from a broad range of market participants and, on that basis, ESMA was able to conclude that minor enhancements were required to FBAs. We believe no evidence of investor detriment exists to justify different conclusions or materially different regulatory action on FBAs at this time.

While we do not agree with ESMA's recommendation for a separate definition for FBAs to better tailor the applicable pre-trade transparency requirements, we welcome ESMA's comments that any proposals to amend RTS 1 in this regard would be subject to public consultation.

We were pleased to see that ESMA's report confirmed there is limited support for the proposal to require disclosure of all orders in FBAs. Full order book transparency for FBAs, when run alongside continuous trading, would indicate the direction of trading interest/market pressure and potentially influence other trading mechanisms. This would result in unnecessary order, cancel and replace activity as participants minimise their information leakage.

We also note ESMA's recommendation to require non-price forming systems to operate under a waiver from pre-trade transparency. We believe this is conflating two separate issues here: Use of the pre-trade transparency waiver is linked to whether or not a mechanism displays prices and volume prior to execution, and not its price-forming characteristics.

In any case, Cboe Europe's Periodic Auctions book is based on an industry standard true price formation process that includes all orders in the order book. The price arrived at is derived from orders in the book itself. The price formation process is a genuine price forming process similar to that utilised in the opening and closing auctions.

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