FESE Views on MiFID II Review for equity market structure and market data

Brussels, 15 February 2021

Key issue & request:

- Fair Competition & Market Structure: MiFID II has permitted the growth of non-transparent venue trading. To the detriment of individual investors, it has unintendedly facilitated a proliferation of Systematic Internalisers (SIs) with reduced transparency obligations. Securing the right market structure for European public capital markets which protects price formation will better serve companies and investors. A well-functioning price formation process is key to the stability and resilience of public capital markets and has a positive impact on the cost of capital for the broader economy.
- Guaranteeing a transparent, high quality, reliable and consistent view of 100% of the market activity, including SI and OTC trades, is key to the functioning of European capital markets and for any consolidated tape (CT) to be considered meaningful. In this respect, a broader implementation of the Market Model Typology (MMT), which currently ensures consistency of exchange data, would contribute to addressing existing SI and OTC data quality issues.
- End investors need to be empowered by ensuring execution quality across all trading opportunities.

How to resolve this?

- It is crucial that the design of the equity market structure takes priority and is simplified. Restricting SI equity trading to large orders (above LIS) only would be an efficient way to incentivise lit trading, ensure the quality and robustness of price formation and removes the complexity currently embedded within the market.
- A pre-condition for a reliable CT is an improvement of SI and OTC data quality, and a coverage of 100% of the transactions. The creation of a “Tape of Record” could represent a cost-effective solution to a CT, avoid latency issues and deliver clear value to the market and investors. Notably, a means to analyse execution quality.

The justification for legislative change:

- MiFID II is core to the organisation of pan-European securities markets and issues within it underpin the current weaknesses in European public capital markets. These should be addressed in a holistic manner.
- We respectfully urge the European Commission to ensure the EU is equipped with a comprehensive vision to strengthen EU public capital markets, both within the Union and on a global basis, and work with the industry to ensure that these markets play a full role in the economic recovery from the Covid-19 crisis as well as accompanying digital and sustainability transformations. We stand ready as European exchanges to participate in this process.

The reality around the EU capital markets remains concerning:

- The EU's global role and weight is declining in the world economy with GDP growth of 1.5% in 2019 (US: 2.3%; China 6.1%) and it has been accelerated by the economic slowdown in 2020 due to the Covid-19 pandemic (sharp drop in GDP of 12.1% in the Euro Area and 11.9% in the EU)[1].
- The structural underdevelopment and fragmentation of EU capital markets has not improved over the last decade. For example, market capitalisation as a percentage of GDP (2018) remained unchanged at 53% in the EU (2009 55%), compared to 148% in the US, 106% in Japan and 88% in Australia[2].
- European exchanges have not maintained the same growth rates of market capitalisation when compared to international players.
- The total number of IPOs in the EU has been steadily declining for years. While there was an annual average of 380 IPOs from 1997 to 2007, the annual average from 2008 to 2018 was only 220 IPOs (US: 179; China 350)[3].
- The EU is lagging far behind on average equity share trading. Equity share trading from 2010 to 2019 was 17% for EU, 50% for Americas and 33% for APAC, while the average number of trades from 2012 to 2020 was 9% for EU, 30% Americas and 61% Asia-Pacific.

While FESE's members were generally supportive of the objectives of MiFID II which included strengthening the price formation process via measures to increase transparency, the results have been disappointing as noted above. In this section, we provide a summary of our views on how the situation could be improved.

Address the challenges raised by fragmentation to ensure a level playing field and a well-functioning price formation process to the benefit of European companies and investors, particularly retail.

- A CMU and a sustainable recovery from the COVID-19 crisis cannot happen without well-functioning secondary capital markets, as primary and secondary markets are two sides of the same coin. If we want companies and investors to (re)enter capital markets, we also need to restore trust in the efficiency, stability and transparency of the markets. Core to this is ensuring that Europe has an optimal price formation process.
- Today, the EU trading landscape is highly fragmented with more than 600[4] registered execution mechanisms for equities and non-equities. This is clearly a complex environment and presents considerable challenges, not only for price formation but also for supervisors to ensure that there is a level playing field.
- MiFID II sought to strengthen price formation in Europe to support companies raising capital and provide confidence for investors, particularly retail, by increasing overall levels of transparency. However, MIFID II has failed to deliver on these ambitions. Since its implementation, overall, we have witnessed lower levels of transparency and a drop of market share on lit venues (to 40%) since a significant share of trading volume is still

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[1] Eurostat, 31 July 2020, *euro indicators*, preliminary flash estimate for the second quarter of 2020, available at https://ec.europa.eu/eurostat/documents/2995521/11156775/2-31072020-BP-EN.pdf/cbe7522c-ebfa-ef08-be60-b1c9d1bd385b.

[2] World Bank, market cap of listed companies (% GDP), available at https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?locations=AU-JP-US-EU&name_desc=false.

[3] Federation of European Securities Exchanges, *European IPO Report 2020*, Recommendations to improve conditions for European IPO markets, available at https://fese.eu/app/uploads/2020/03/European-IPO-Report-2020.pdf, p. 10.

[4] ESMA statistical report on EU securities markets (2020) - Combining equities and bonds, European securities are traded on 430 trading venues (TVs) registered in the EEA at the end of 2019: 135 regulated markets, 223 multilateral trading facilities and 72 organised trading facilities. In addition, there were 216 systematic internalisers (SIs), with an increase of 47 SIs since the beginning of 2019

executed off-venue (OTC at 27% and SIs at 20%, dark trading at 3%)[5] or under permitted waivers[6];

- A strengthening of price formation is dependent on an increase in overall transparency of secondary markets. In our view, the priority should be to simplify the EU's equity market structure with a view to achieving more transparency, efficiency and fairness in EU markets.
- Beyond enforcing existing rules, it is key to ensure that SI venues are held to the framework to which the original rules intended, that of providing for LIS trades. To this aim, a tightening of the SI regime is necessary which would include increased transparency requirements and restricted trading by SIs to above or at least up to a percentage of LIS thresholds.
- Alongside strengthening the price formation process for the benefit of European companies, an overarching focus should be placed on the interests of end-investors, notably retail investors. The CMU Action Plan includes a point on ensuring that retail investors receive fair advice as well as clear and comparable product information.
- However, in our view this should be complemented by further measures to ensure that retail investors are actually receiving best execution when they trade in European capital markets. This is a critical to ensuring that investors, particularly end investors, have the confidence to participate in European public markets.
- In particular, there should be a focus on venues which offer zero fees trading for retail investors as well as payment for order flow regimes. Some FESE members have conducted extensive research in this space to demonstrate that, regardless of the zero fees offer, best execution is not often achieved on these venues proving that rent is still extracted despite the headline offer in an in-transparent manner.

Increase data quality for a globally competitive EU capital market.

- Data quality originating from OTC and SI trading remains deficient, which mainly results from fragmentation and exemptions from the transparency and reporting regime. Therefore, data quality, consistency and availability at the source, has to be improved as a matter of priority.
- An EU consolidated tape provider (CTP) will not be a silver bullet for resolving the identified issues around transparency and price formation, particularly in respect of the market structure issues discussed above. When it comes to trading on lit venues, the majority of volume is covered by existing data providers. The real problem, and the challenge for a comprehensive CTP to be in any position of adding value, is the lack of data quality from the grey and dark parts of the market which aligned with the fact that trading activity from these parts of the market is not addressable by many investors makes the output less reliable.
- Importantly, without improving transparency by addressing OTC-data quality and loopholes in the SI regime in the first place, such a CTP would constitute another data aggregation exercise without any clear regulatory use case but at an additional cost for market participants.

[5] ESMA statistical report on EU securities markets (2020)

[6] At the height of the COVID-19 crisis, investor demand for fair and transparent markets was evident and again illustrated by the 'flight to quality' in times of market stress. We saw migration of volumes from dark, Systemic Internalisers (SI) and OTC trading to lit markets as the reference point for price determination – but also a reversal of this trend once the days of highest volatility had passed.

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- Following verifiable improvements to off-venue data quality, FESE suggests policymakers consider, within the assessment of the options, the proposal of a Tape of Record as a viable alternative to the CTP. It could be delivered within a significantly less complex and costly technical set-up and would provide a comprehensive overview of liquidity within the EU on an instrument level and allow for best execution controls to the benefit of investors and listed companies.
- We agree to an EU CTP but not one that favours global players and places more costs on EU firms. Global players want a tape that only shows prices of transparent markets, claiming that only “addressable liquidity” should be on the tape, this means that significant volumes of business conducted by these global payers will not be on the EU tape and therefore will not address transparency issues. On the contrary, it is key that 100% of transactions are on the tape, so that market dynamics are understood and transparent.
- Through the tape, some market participants want to get market data for free and then use this data for commercial purposes to execute orders allowing them to internalise commissions and earn the spread between buyers and sellers, but this is depriving transparent markets of their investments and opportunistic rent reallocation. It is also important to be careful when certain market participants speak about the costs of market data: they often mean data which does not fall into the generally accepted understanding of market data as they use many other types of data. Exchange market data fees account for less than 0.5% of buy-side and 10% of sell-side market data spend.