



An analysis of AFME’s report “The landscape for European equity trading and liquidity”: FESE calls for greater transparency in a now overly complex European market infrastructure

Brussels, 1st June 2021

On 1st June 2021, the Association of Financial Markets in Europe (AFME) published the report prepared by Oxera “The landscape for European equity trading and liquidity”.¹

Importantly, the AFME Report questions the empirical evidence published by the European Securities and Markets Authority².

By contrast to AFME, FESE believes that the EU’s securities markets should be made more transparent and simple. In particular, the MiFID II/ MiFIR Review should address the current issues of complexity, opacity and intransparency into the EU’s securities markets, notably to the detriment of the EU’s society as a whole.

The Federation of European Stock Exchanges (FESE) believes that AFME’s reasoning is significantly flawed by failing to understand the important societal function that capital markets, and in particular equity markets, play. AFME’s report argues that “equity trading markets exist to provide a meeting point for buyers and sellers of stocks, and trading and the provision of liquidity are about enabling investors to buy and sell securities.”

This starting point tries to undermine the important differences between primary and secondary markets. Much beyond being a “meeting point”, primary markets deliver critical functions for our society, notably by providing IPOs, financing the EU’s real economy and enabling investors, including the ordinary citizen, to participate in wealth creation.

In light of the Covid-19 pandemic, significant pressure on public finances, a constraint banking system, the EU’s challenge around the Brexit, the questions around the future of pensions systems as well as the financing of transformational challenges, such as climate change or digitalisation, FESE welcomes the EU’s extensive capital markets policy agenda.

In particular, we believe the report incorrectly mixes technical transactions and trades without an economic trading interest and does not yield any insight on how pre-trade transparent trading has evolved since MiFID II - something at the core of the legislation.

Furthermore, the report argues that increased trading in transparent venues could increase spreads and decrease liquidity, competition, and investor choice. This goes against empirical and theoretical evidence. Dark venues can be detrimental to price formation and liquidity. Trading in dark venues reduces the information available for the price formation process as most dark orders could contribute to price formation. By reducing the depth in transparent order books, dark trading fragments the order flow, which can have adverse selection risks and result in higher spreads.

¹ Oxera, “The Landscape for European Equity Trading and Liquidity” (Oxford, 2021).

² ESMA, “ESMA Annual Statistical Report - EU Securities Markets” (Paris, 2020).

FESE believes that the EU's securities markets should be made more transparent and simple. In particular, the MiFID II/ MiFIR Review should address the current issues of complexity, opacity and intransparency of EU's securities markets

After the MiFID II/ MiFIR application has resulted in the growth of the amount of trading solutions, especially with the establishment of more than 240 SIs, FESE is of the view that the MiFID II/ MiFIR Review should in particular address the current share of lit-trading, in light of the original goals of policymakers during the MiFID/ MiFIR negotiations.

Catering to those goals, a thoughtful discussion on the structure of market models and the regulatory approach towards transparent trading is vital.

Especially in light of recent market observations, such as payment for order flow which potentially could create conflicts of interests, FESE underlines the need for transparent, fair and equitable securities markets that do not only represent the wholesale interests of a few.

1. Core claims by AFME

The two main conclusions of the report are:

- *“OTC and SI trading combined accounted for 17% of European equity trading. The share of on-venue trading was 83% ... [Their] estimates of the share of OTC and SI trading (irrespective of the filter applied) are significantly lower than the 47% share estimated by ESMA.”*
 - ➔ **Precisely this inconsistency with ESMA figures³ indicates that the reports' conclusions are flawed and are based on cherry-picking and inaccurately removing data. The report incorrectly mixes technical transactions and trades without an economic trading interest and does not yield any insight on how pre-trade transparent trading has evolved since MiFID II - something at the core of the legislation.**
- *In the report, it is argued that increased trading in transparent venues could increase spreads and decrease liquidity, competition, and investor choice.*
 - ➔ **This goes against empirical and theoretical evidence. Dark venues can be detrimental to price formation and liquidity.⁴ Trading in dark venues reduces the information available for the price formation process as most dark orders (given their small sizes) could contribute to price formation. By reducing the depth in transparent order books, dark trading fragments the order flow⁵, which can have adverse selection risks and result in higher spreads.**

³ ESMA, “ESMA Annual Statistical Report - EU Securities Markets” (Paris, 2020).

⁴ Haoxiang Zhu et al., “Do Dark Pools Harm Price Discovery?,” 2012; Monica Petrescu and Michael Wedow, “Dark Pools in European Equity Markets: Emergence, Competition and Implications,” *ECB Occasional Paper Series*, 2017, <https://doi.org/10.2866/555710>.

⁵ Hans Degryse, Frank de Jong, and Vincent van Kervel, “The Impact of Dark Trading and Visible Fragmentation on Market Quality,” *Review of Finance* 19, no. 4 (July 1, 2015): 1587-1622, <https://doi.org/10.1093/rof/rfu027>; IOSCO, “Issues Raised by Dark Liquidity” (Madrid, 2010).

2. Core recommendations by FESE

Against this background, policymakers and regulators must reflect on the most appropriate market structure. Transparent markets must be at the core of equity markets to fulfil two core functions:

- The provision of trading with large pools of liquidity and price formation: a well-functioning price formation process delivers more efficient and fairer markets benefiting investors, and lowers the costs of capital for businesses.⁶
- The proper functioning of capital markets and for investors: transparent, orderly, and non-discriminatory markets are key to achieving this.

In assessing these issues, it is also important to adopt a comprehensive approach and recognise that poor data quality in systematic internaliser (SI) and over-the-counter (OTC) trade reporting undermines a proper understanding of market structure.

3. The flaws of the report in the filtered analysis by AFME

The conclusions reported are based on the premise that a very large number of trades “are technical in nature and do not represent economic trading interest”.

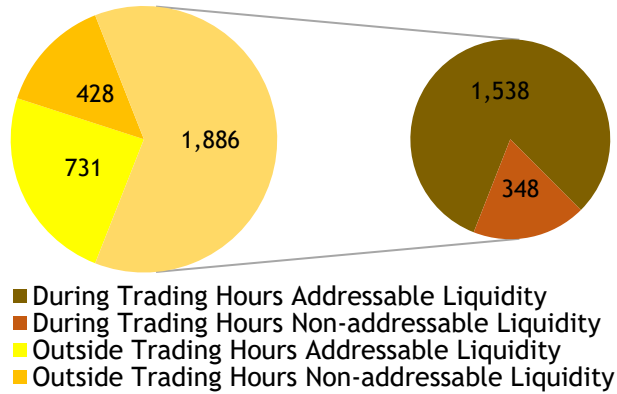
This assumption is misleading in several aspects:

- First, given that there exist multiple definition and data quality issues, disaggregating technical trades like non-price forming trades (trades under the TNCP flag) is not a good starting point for a general analysis on market structure since it would overlook a large number of transactions. Whilst in this debate it is important to recognise the distinction between price-forming and non-price-forming transactions, a significant number of non-price forming transactions (like those executed under the negotiated transaction waiver) is addressable and would even be price forming if executed on a trading venue. Accordingly, a large number of trades filtered in the report correspond to liquidity that could have interacted with multiple trading interests and represent economic trading interest.
- Second, to exclude trades occurring outside of trading hours, as the report does, is wrongly to assume that the entirety of those trades has a technical nature. In view of another report by AFME also recommending⁷ that a significant proportion of large-in-scale (LIS) trading should be classified as non-addressable, it should be underlined that the LIS waiver exists precisely to reduce market impact, technical trades and large trades should not be equated. As an example of the problematic nature of extensive filtering out, we can observe that non-addressable trades and trades outside trading hours constitute a significant fraction of SI trading and they should not be overlooked.

⁶ Yakov Amihud, Haim Mendelson, and Lasse Heje Pedersen, *Market Liquidity: Asset Pricing, Risk, and Crises* (Cambridge University Press, 2013); Viral V. Acharya and Lasse Heje Pedersen, “Asset Pricing with Liquidity Risk,” *Journal of Financial Economics* 77, no. 2 (August 1, 2005): 375-410, <https://doi.org/10.1016/j.jfineco.2004.06.007>.

⁷ AFME, “Understanding the Liquidity Landscape in European Equity Markets” (London, 2020).

STOXX 600 SIs Turnover in 2020 (EUR billion)

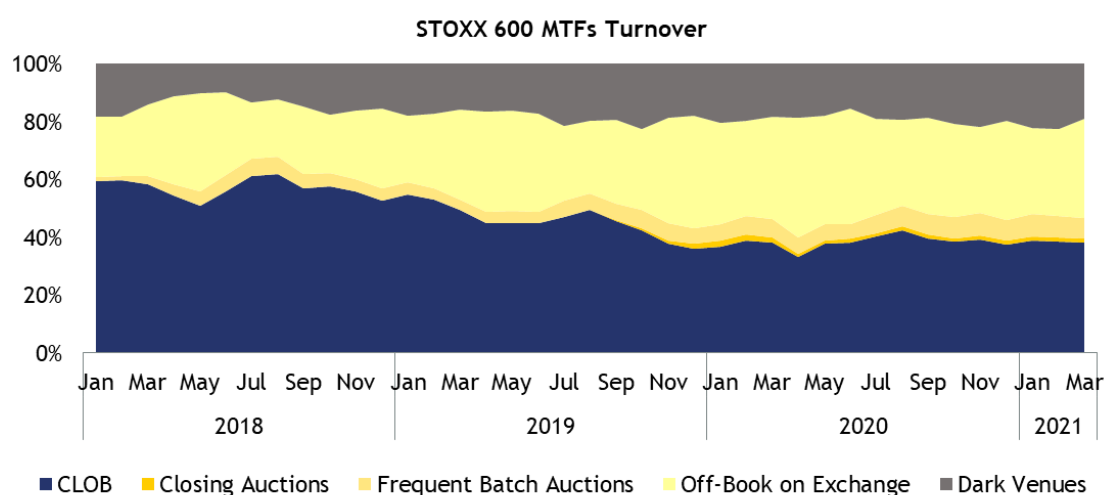
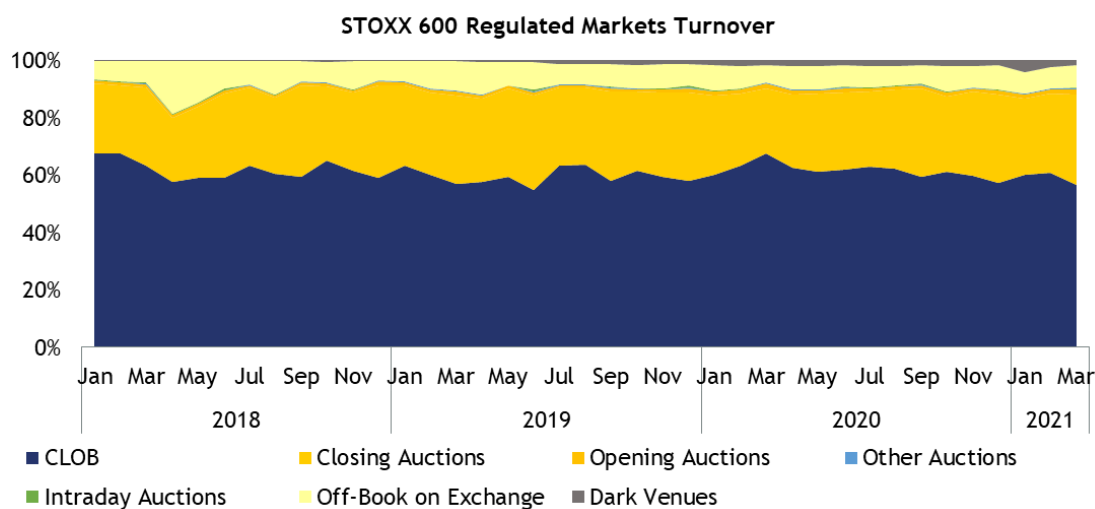


Source: Big xyt, FESE analysis

- Third, the categorisation is based on trade flags populating individual incoming trade reports. This categorisation can only be as good as the data quality of such individual granular trade reports. Regrettably, SI and OTC trade reports are of poor quality, because different SI and OTC trade reporting operators often apply different flagging logic for similar use cases. The categorisation consequently ends up being misleading as similar types of executions fall into different categories. The AFME data source is a vendor providing ex-post analytics services. Unlike trading venues that have full insight over the order and transaction processing lifecycle, vendors do not have such understanding.

AFME is consequently not in a position to have an informed view of the quality of incoming data from SI and OTC trade reports and should not disaggregate them. The report itself states that “it is possible that applying a filter based on the TNCP flag alone may over-estimate the number of technical transactions.”

- Another issue with the report is that adding trading venue volumes does not yield pre-trade transparent trading, the focus of MiFID II/ MiFIR. There is a marked difference when considering the multilateral mechanisms offered by regulated markets and multilateral trading facilities (MTFs). The majority of turnover for regulated markets is pre-trade transparent, compared to less than half for MTFs which offer dark trading and block trading that does not contribute to price formation. Finally, it is important to remark that only considering EU entities for an assessment of market structure would be problematic for two reasons:
 - The majority of OTC transactions are reported via UK-approved publication arrangements (APAs).
 - SI volumes are also dominated by UK entities.



Source: Big xyt, FESE analysis

4. The unfiltered reality: EU capital markets are competitive but less and less transparent

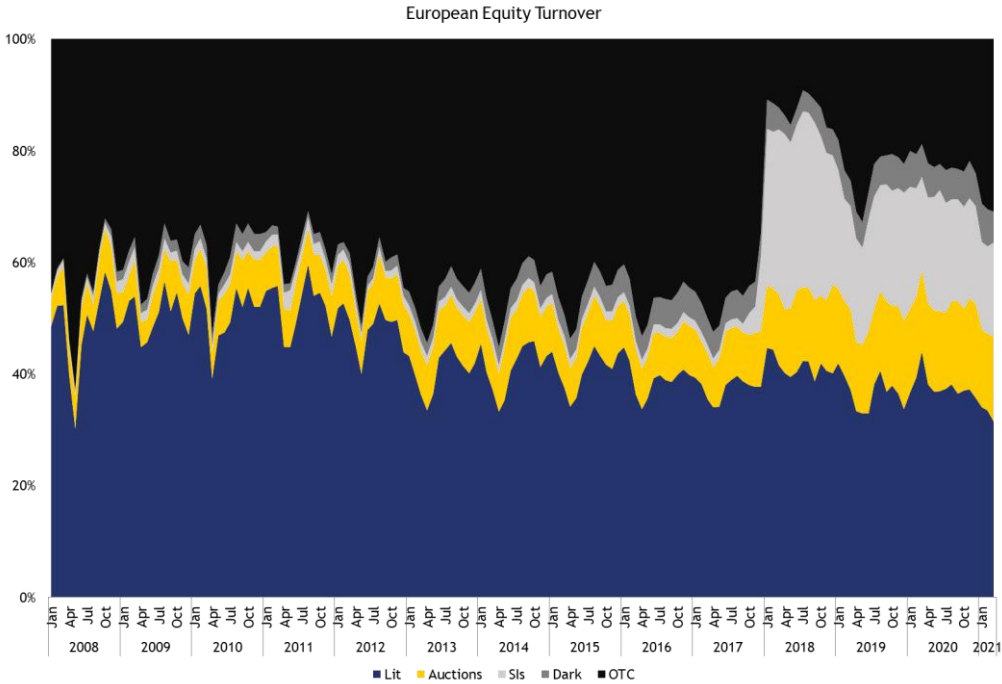
MiFID II/ MiFIR was established with the objective of making “financial markets in the EU more robust and transparent”, by creating a “legal framework that better regulates trading activities on financial markets and enhances investor protection.”⁸ Thanks to the share trading obligation and broader reporting obligations, more transparency and competition were brought to equity markets and the range of execution venues expanded. However, the multiplication of alternative venues, currently numbered in the hundreds, inevitably brought additional fragmentation and difficulties in sourcing liquidity.⁹

SI and OTC trading have proliferated, characterised by limited to no pre-trade transparency and their lack of contribution to the price formation process.

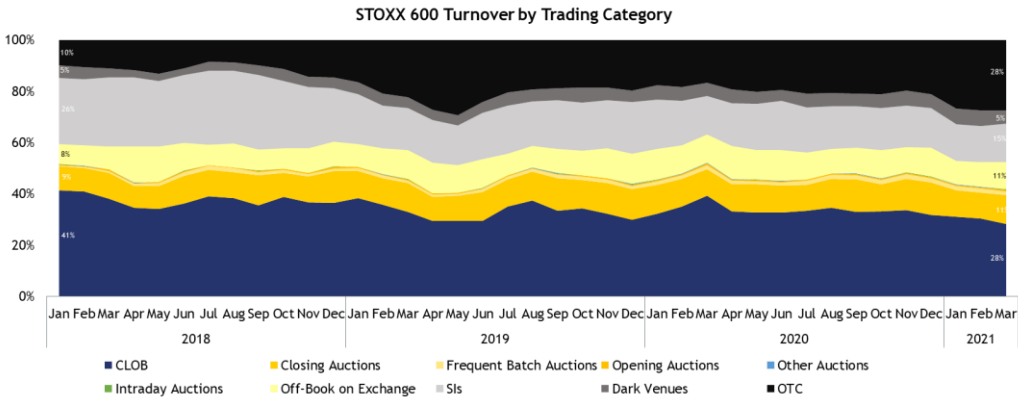
⁸ EUR-Lex, “Better Regulated and Transparent Financial Markets,” 2017, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM%3A240405_3.

⁹ There are more than 600 venues currently operating in the EU for all asset classes, according to the ESMA MiFID II/MiFIR TV/SI/DRSP database.

When considering the whole set of transactions to get the full reality, these two hundred SIs together with OTC trading currently represent about 40% of the market. This post-MiFID II pattern is repeated when looking at multiple execution mechanisms, some of them largely pre-trade transparent like central limit order books (CLOB), others opaque like frequent batch auctions (FBAs), others opaque like frequent batch auctions (FBAs).



Source: CFA Institute (2011), Gomber et al. (2016), Oxera (2020), and Big xyt



Source: Big xyt