Towards a European market structure that works for all investors

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An efficient market structure is a prerequisite for a successful Capital Markets Union (CMU). The EU needs a market architecture that funds the economy in the most inclusive and fairest way for all investors. European regulations like MiFID II/MiFIR provide some tools to support this vision. However, whilst the CMU is striving to improve the funding of the economy and foster investment, capital markets still present significant challenges for issuers and investors:

- Transparency can be improved;
- Retail investors do not have access to most venues;
- Conflicts of interest are not always well-managed;
- Retail participation is limited.

One of the keys to overcoming these challenges is in the intrinsic nexus of market structure with issuers and investors. The EU needs a market architecture that works for everyone, provides efficient price formation, fair competition and interaction among market participants, and delivers best execution. Trading venues are well suited to deliver on all those aspects for two fundamental reasons. First, transparent markets with deep pools of liquidity are a crucial component of price formation and best execution, as well as an important contributor to market resilience. Second, trading venues efficiently balance greater investor participation with investor protection and confidence. Investors are treated in a non-discriminatory and transparent way and conflicts of interest are well-managed.

Trading venues should be promoted to strengthen the CMU, without denying the need for investors, professional and retail, to access different types of venues. Recent months have seen significant growth of retail participation in capital markets across the EU, while still at a level far below that observed in the US.[1] This trend should be supported through adequate measures, whilst preserving investor protection and guaranteeing an efficient and competitive equity market structure.

What is the current situation in capital markets regarding investors?

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."[2] Thanks to the share trading obligation and broader reporting obligations, more transparency was brought to equity markets and the range of execution venues expanded. However, the multiplication

[1] Steven Maijoor, "'Retail Investors and Asset Management Are the Pillars of a Successful Capital Markets Union'" (ESMA, 2020).
[2] EUR-Lex, "Better Regulated and Transparent Financial Markets," 2017, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM%3A240405_3.

of alternative venues inevitably brought additional fragmentation and difficulties in sourcing liquidity.[3] Systematic internaliser (SI) and over-the-counter (OTC) trading have proliferated, characterised by limited to no pre-trade transparency and their lack of contribution to the price formation process. Moreover, some of the largest SIs or non-EU-based MTFs do not seem to meet regulatory standards regarding access for retail investors. For example, market data is hardly accessible, complete, or timely on their public websites, contrary to MiFID II/MiFIR and to the detriment of the retail investor.[4]

Against this background, policymakers and regulators must reflect on the most appropriate market structure. Transparent, orderly, and non-discriminatory markets are key for the proper functioning of capital markets and for investors. In FESE's view, a streamlined approach to market structure is required based on a simple and essential premise: trading below large sizes should contribute to the price formation process and to investor participation.

Why are transparency and price formation important for investors?

Establishing the right market structure for capital markets will protect transparency and price formation, thereby serving issuers and investors. A well-functioning price formation process is key to the stability and resilience of capital markets, socialises the spread, and has a positive impact on the cost of capital for the broader economy. The safe harbour nature of regulated markets, which offer a transparent and robust price formation process is of value for all market participants. At times of crisis, such as the current COVID-19 pandemic and the consequent market volatility, more trading volumes go to regulated markets.

Conversely, by reducing the depth of lit order books, dark trading and price referencing fragment the order flow. This situation leads to adverse selection risks and higher spreads for investors.[5] Fragmentation can impede or dilute price formation, as fewer market participants come together on any lit market, while dark and price referencing venues are using the reference prices provided by lit venues. Hence, transparent and non-discretionary pricing mechanisms go hand in hand with enhanced best execution as well as strengthened price formation.

How do unfair trading rules impact investors?

A core aspect of meeting investor needs is to be open to all investors. Retail access to capital markets is key for the CMU. The investor community is diverse, especially in terms of sizes, volumes, and demanded instruments, and must be able to interact fairly in the market. Unfair or discriminatory rules impact disproportionately the retail investor and there is an intrinsic connection between these smaller investors and SME markets and issuers, which constitute the vast majority of IPOs and listed companies in the EU. All investors should have the ability to access financial markets and be adequately informed and protected in order to decide which instruments best suit their investment needs.

Trading venues contribute to this objective. They must facilitate access for investors, and are subject to non-discriminatory rules and differentiated market abuse requirements. In

[3] 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.

[4] Better Finance, "Consumer Access to EU Equity Trade Data" (Brussels, 2021).

[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).

FESE Avenue de Cortenbergh, 116, 1000 Brussels — info@fese.eu — +32 2 551 01 80

contrast, SIs and OTC markets are able to discriminate regarding whom they choose to do business and are not open to all investors. SIs may choose the size at which they wish to quote or decide which clients have access to their quotes. Conflicts of interest are frequent in some of these venues. For example, payments for order flow create a conflict of interest between brokers and SIs, distort competition, and may increase bid-ask spreads, undermining price formation and best execution.

Which concrete approach should be taken in the review of MiFID II/MiFIR?

Whilst for large orders there is a need for alternative execution mechanisms (that benefit from transparency waivers) to prevent information leakage and market impact, all market participants should benefit from transparency and fair rules. Some proposals by ESMA[6] aim at improving the transparency regime and are a step in the right direction, but more is needed given the described trends and issues.

FESE's proposal for a simplified market structure proposes transparency for trades below large sizes, introduces higher minimum quoting sizes, minimum fill rates and authorisation requirements for SIs, and scrutinises best execution and payments for order flow. If implemented, it would reduce market fragmentation and increase liquidity and transparency, allowing all investors to better interact and access markets, in particular retail investors.

All investors stand to benefit from fairer prices and rules. This market structure proposal would enhance the ability of MiFID II/MiFIR to increase investor access, protection and choice, as well as to further the level playing field, as it would equally apply to all types of execution. With the FESE proposals, trading venues could best support well-functioning capital markets in line with the CMU's objectives.

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 18 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of April 2021, FESE members had 9,112 companies listed on their markets, of which 14% are foreign companies contributing towards European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access capital markets; 1,263 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.

FESE is registered in the European Union Transparency Register: 71488206456-23.

6 ESMA, "MiFID II/ MiFIR Review Report on the Transparency Regime for Equity and Equity-like Instruments, the Double Volume Cap Mechanism and the Trading Obligation for Shares" (Paris, 2020).