BF BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

Ref: ESMA Consultation Paper on MiFID II/ MiFIR review report on the transparency regime for equity and equity-like instruments, the double volume cap mechanism and the trading obligations for shares

Link to consultation: https://www.esma.europa.eu/press-news/consultations/consultation-mifid-ii-mifir-review-report-transparency-regime-equity-and.

Link to paper:
https://www.esma.europa.eu/sites/default/files/library/cp_review_report_transparency_equity_dvc_tos.pdf

---

BETTER FINANCE Response

Summary

General comment	BETTER FINANCE welcomes this public consultation from ESMA – even if its language and content is definitely not intelligible to EU citizens as individual investors – as the lack of transparency of the now dominating "dark" venues is generating a serious detriment to them and to the real economy. Although the purpose of MiFID II/MiFIR and the new systematic internaliser (SI) regime was to reduce "dark" cross broker networks and bring back more securities trading to "lit", regulated markets, a legislative loophole in the new regulatory framework has caused a backfire, with a 16x fold increase in the number of SIs and a 5x times increase in "dark" trading of European equity and equity-like instruments. This has significantly affected the process of price discovery, poses significant threats to investor protection and creates a serious detriment (and erosion of trust) for individual, non-professional investors' participation in capital markets. It is also quite inconsistent with the main objectives of the "CMU" (Capital Markets union") initiative.
Large-in-scale threshold	For BETTER FINANCE, it seems obvious that the double-volume cap and the SI regime have not achieved their purpose. Therefore, we propose a simplification of the market structure and a delimitation of dark-lit trading (both OTC and SI) based on a higher large-in-scale (LIS) threshold.

About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

Instructions on how to read this paper: this document contains BETTER FINANCE's stylised response to ESMA's Public Consultation but it is not the actual response form submitted.[1] Due to the technicality of the subjects in scope, BETTER FINANCE chose only to present a general view and answer one question under Section 3 on the transparency of equity and equity-like instruments.

The general comment below represents BETTER FINANCE's position regarding the evolution of equity trading in the EU post-MiFID II.

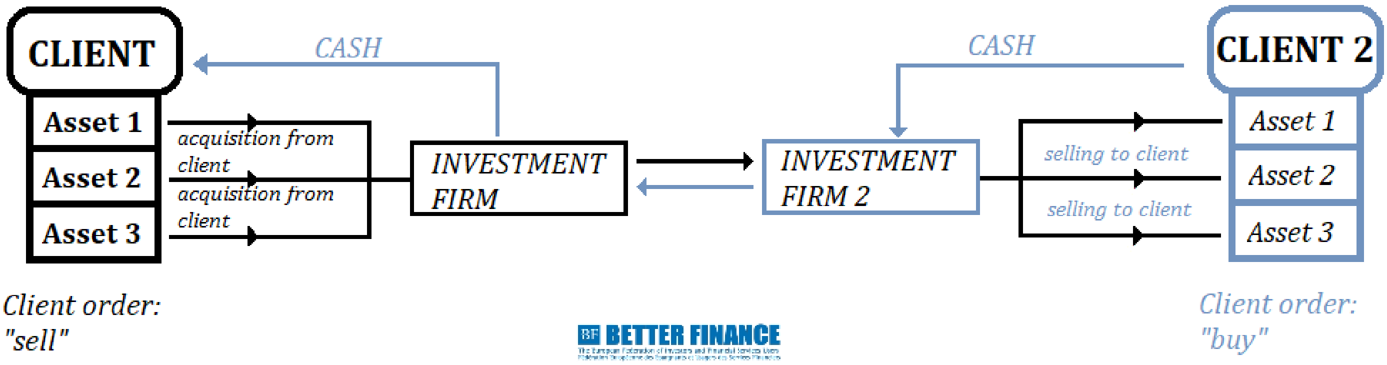
Background information

Trading in financial instruments (equities, bonds, investment funds shares, etc.) can take place publicly – through regulated – "lit" - trading facilities (securities exchanges, stock markets) – or privately (over-the-counter, OTC) – also quite appropriately referred to as dark trading.

Public trading		"Dark" trading	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
Transparency	Regulatory burdens	Lower fees (?)	Price vulnerability
Non-discretionary rules	Higher costs	Bilateral executions	Lack of transparency
Real price formation	Order size limits	Large orders with less price movement	Potential conflicts of interests

However, "dark" trading must be exceptional, meaning that the volume of securities traded on such platforms should reflect its exceptional character. To achieve this, the new MiFID II provisions attempted to extend the regulatory arm on a significant part of dark trading and bring them to "lit" trading facilities. Nevertheless, as warned by ESMA before the entry into force of the new MiFID II/MiFIR provisions, a legislative loophole allowed many investment firms (mostly Anglo-Saxon) to set-up their own *systematic internalisers* (SI) and escape these provisions. An SI describes an investment firm which buys and sells securities on the basis of their clients' orders but using their "own" capital.

FUNCTIONING OF SYSTEMATIC INTERNALISERS



Source: BETTER FINANCE own composition

The risk of trading too much on dark pools such as SIs is the distortion of the price formation process – which is a founding pillar of capital markets, allowing for the fair valuation of assets and

[1] The ESAs JC require to fill in a pre-formatted, standardised response form; we have chosen to change the format to make it more reader-friendly, to include background information and summaries for less knowledgeable readers and streamline comments, where possible. These issues are highly technical and affecting directly only wholesale professionals, but they have an important impact on EU citizens as individual investors and pension savers. Therefore, BETTER FINANCE urges ESMA to communicate in intelligible terms for EU citizens about these public policy issues at stake and their potential impacts on people.

thus optimal allocation of capital. Ultimately, those who "pay the price" of excessive dark trading will be individual, non-professional investors and companies as issuers of transferable securities (shares, bonds). In reverse, arbitrary and opaque order matching will mostly benefit investment firms organising such platforms. SIs appear mostly as free riders, feeding on the trade data from the price formation offered by regulated markets (RMs) to extract profit margins. Also, SIs mostly extract information concerning the most liquid stock trading (blue chips), leaving the less liquid (and therefore more challenging and less profitable, but very important for the EU economy) small and mid-cap stock price formations to the RMs.

EU citizens as non-professional investors are particularly hurt by the dark trading becoming so large and now even getting bigger than trading on lit market venues. The dark venues (SIs in particular) bear none of the key transparency requirements of the RMs. Worse:

- None of their pre- and post-trade data are directly and easily accessible to individual investors, contrary to those of the RMs;
- Individual investors are not even aware of their existence behind the screen, and most do not even have a clue of what "dark venues" and "SIs" could mean, although they know quite well who the RMs are.

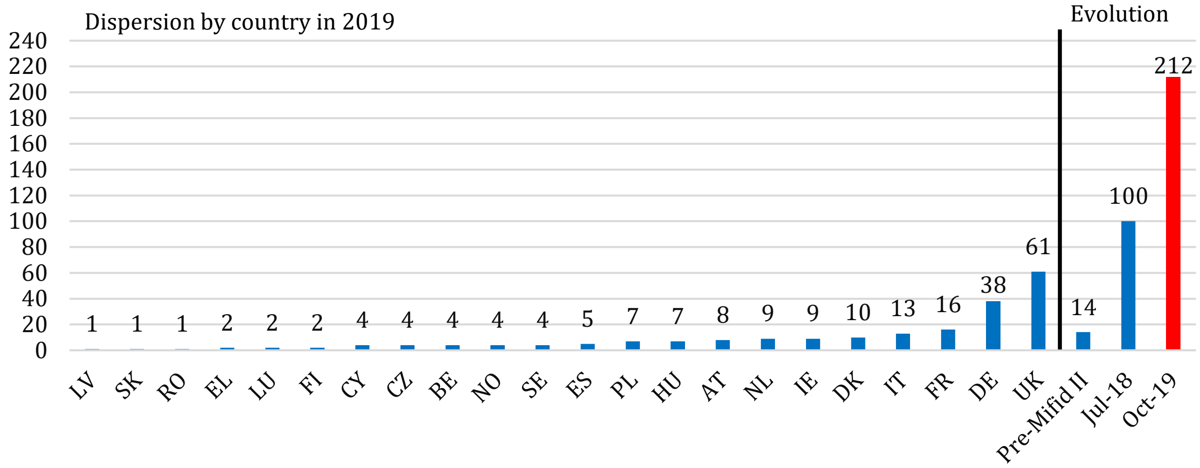
1. General comment

Specialised literature and news publications predominantly warned pre- and post-MiFID II about the "backfire" the new provisions concerning systematic internalisers would have on equity trading in the EU.[2] Based on research done at the time, approximatively 9% of equity trading took place on over-the-counter (OTC) basis before January, 1st, 2018 – and this was a cause determining the EU co-legislators the amend MiFID I provisions on systematic internalisers (SIs), extending the obligations to non-equity instruments as well (e.g. bonds).

However, as the purpose of these new provisions was to "kill" cross broker networks, limit SI-trading and bring more shared and bond transactions to lit markets, we have seen a proliferation of "opt-ins" for SIs – in particular by banks – and a dramatic decrease of transparency in equity trading. According to ESMA registers, at the time of writing this response, out of the 223 SIs registered, we estimate more than 90% are banks.

[2] See ESMA Letter of 1 February 2017 to DG FISMA Director General concerning "MiFID 2 – Sis operating crossing broker networks" – ESMA70-872942901-19, https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-19_letter_chair_guersent_si_0.pdf; see Sviatoslav Rosov, 'MiFID II: ESMA Races to Close the Systematic Internalisation Loophole' (13/07/2018, Market Integrity Insights, blog.cfainstitute.org), accessed at https://blogs.cfainstitute.org/marketintegrity/2017/05/03/mifid-ii-esma-races-to-close-the-systematic-internalisation-loophole/; Sviatoslav Rosov, 'MiFID II and Systematic Internalisaer: If Only Someone Knew This Would Happen' (03/05/2017, Market Integrity Insights, blog.cfainstitute.org), accessed at https://blogs.cfainstitute.org/marketintegrity/2018/07/13/mifid-ii-and-systematic-internalisers-if-only-someone-knew-this-would-happen/; Phillip Stafford, Hannah Murphy, 'Regulators Urged to Close European Share Trading Loophole' (21/02/2017, ft.com) accessed at: https://www.ft.com/content/33c854ee-f781-11e6-9516-2d969e0d3b65;

Number of SIs in the EU



__Source__: excerpt from BETTER FINANCE CMU Assessment Report 2015-2019;

Nowadays, research shows that almost a half (at times, more) of equity trading takes place OTC through these newly formed SIs. For instance, data concerning the European all-cap index (STOXX Europe 600) shows that 40% of the turnover was on dark venues, which not only affects the price formation of European companies' financial instruments, or market liquidity, but disincentivises individual investors from participating in capital markets due to the opaqueness therein.

It seems obvious to us that the new regime for SIs and the double-volume cap have not achieved their purpose and new measures must be taken to at least revert the situation in European equity trading.

We reiterate the fact that pre- and **post-trade transparency is a prerequisite for individual, non-professional investors to regain trust in capital markets**, obtain the necessary information and buy and hold more directly listed securities. Moreover, this would also contribute to European undertakings going private and selling their transferable securities on "lit" markets.

Fair, transparent and adequately functioning securities exchanges (and, more general, market structures) is key for the achievement of the CMU project. The CMU must incentivise and lay the grounds for a robust, fair and transparent price discovery, allowing European citizens and businesses to benefit of the real value resulting from the buy-sell encounter. Moreover, more trading on regulated trading facilities (regulated markets, multilateral-trading facilities and organised-trading facilities) would enhance liquidity and bring significant cost efficiency gains for individual investors.

As mentioned in BETTER FINANCE's Key Priorities 2019 – 2024 and in BETTER FINANCE's CMU Assessment Report 2015-2019, bringing individual investors closer to regulated markets, allowing them to directly invest in the European economy, and making capital markets more accessible and more attractive for SMEs are founding goals for the Capital Markets Union (CMU) project and for making it strong, resilient and "that Works for People".

2. Alternatives to increase lit trading

Short summary: *ESMA seeks views from stakeholders on its proposals to increase trading on regulated trading facilities in the EU with measures such as removing waivers, prohibiting the use of combined waivers or increasing the large-in-scale threshold. The following question asks stakeholders whether alternatives to what ESMA proposed are envisaged.*

Q6: What would be in your view an alternative way to incentivise lit trading and ensure the quality and robustness of the price determination mechanism for shares and equity-like instruments? Please explain.

BETTER FINANCE acknowledges the necessity of allowing certain large trades to take place outside regulated markets so as to not distort price formation or generate a significant market impact. However, as we pointed out above, and resulting from the essence of such large trades, these must be ***exceptional***.

In our view, in order to enable capital market structures' full potential, the vast majority of equity trading should be subject to information and protection rules for individual, non-professional investors. Pre- and post-trade data should be available for free and easily accessible at the very least 15 minutes after the trade takes place not only for RMS as it is the case today, but **also for dark venues**, and should cover the entire market, i.e. blue chips/large caps and SMID caps.

In order to increase investor protection and limit dark trading on financial markets – affecting the price formation process, BETTER FINANCE puts forward an alternative recommendation to remove the double-volume cap – which has proved inefficient – and replace it with a much higher large-in-scale threshold, thus simplifying the market structure rules and avoiding the regulatory loophole.

As such, SI trading could take place – justifiably – only for those orders that are sufficiently sizeable in order to warrant such an exception on the basis of the market impact it would generate while, at the same time, making sure that their occurrence is only exceptional, therefore keeping in place the transparency of trades through public markets and maintaining pre- and post-trade reporting in real time. In other words, ESMA should consider the large-in-scale threshold (and, hence, reporting waiver) as the single criterion to delimit lit from dark trading. We believe that this would disincentivise SI creation for average trades, bring back most of equity and equity-like instruments on regulated trading facilities, and address the issue created by the new MiFID II/ MIFIR provisions. Moreover, this criterion could be extended to all dark trading, thus eliminating the other reporting waivers under MiFID II/MiFIR and the double-volume cap.

***

Contact:

info@betterfinance.eu

+32 (0) 25 14 37 77