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FESE Response to ESMA Consultation on RTS 1

Introductory remarks

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 20 Full Members from 29 countries, as well as 1 Affiliate Member and 1 Observer Member. FESE represents public Regulated Markets, which provide both institutional and retail investors with transparent and neutral price-formation.

At the end of 2016, FESE members had 8,982 companies listed on their markets, of which 6% are foreign companies contributing towards the 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 the capital markets; 1,291 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers.

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

Summary FESE response

FESE strongly supports ESMA's proposal to clarify that Systematic Internalisers' quotes would only reflect prevailing market conditions where the price levels could be traded on a trading venue at the time of publication. We welcome ESMA's initiative to clarify this issue which we consider to be a necessary development in order to deliver on the objectives of MiFID II/MiFIR and therefore urge ESMA and the Commission to move speedily to adopt this amendment to the Level 2 framework.

Whilst the ESMA proposal to amend RTS 1 is a step in the right direction, the market above Standard Market Size (SMS) is still open to the risk of tick size arbitrage by SIs. In light of this, FESE is supportive of calls for an amendment to the Level 1 framework to extend the minimum tick size regime to SIs trading in all sizes. In advance of such Level 1 changes being agreed upon and implemented, FESE believes it would also be worth exploring additional interim solutions within the Level 2 framework which could be applied relatively quickly. Such an approach could involve a small revision to the methodology for the SMS calculation with a view to increasing the level and thus covering larger orders.

Response to questions

Question 1: Do you agree with ESMA's proposal to clarify that SIs' quotes would only reflect prevailing market conditions where the price levels could be traded on a trading venue at the time of publication?

FESE strongly supports ESMA's proposal

FESE strongly supports ESMA's proposal to clarify that Systematic Internalisers' (SIs) quotes would only reflect prevailing market conditions where the price levels could be traded on a trading venue at the time of publication. FESE considers that this is a very welcome recognition by ESMA and a necessary development in order to deliver on the objectives of MiFID II/MiFIR. We therefore urge ESMA and the Commission to move speedily to adopt this amendment to the Level 2 framework.

Policy makers and regulators need to address loopholes in the SI regime

Recent measures taken by regulators to address loopholes in the SI regime should be assessed against the backdrop of the original intentions of the legislator.

The SI was introduced under MiFID I to allow investment firms to execute client transactions against their own proprietary capital. Given the bilateral and risk-taking nature of the regime, SIs were only mandated to publish buy and sell quotes up to standard market size (SMS) (this being EUR 10 000 for most shares) for a minimum size of 10% SMS. The Commission's original proposal and the final legislation, in recognising that SIs serve a legitimate and distinct purpose, are clear that they should not bring together third party buying and selling interests in functionally the same ways as a Regulated Market, MTF or OTF (the latter in respect of non-equities). The framework therefore explicitly excludes SIs from the definition of trading venues[1]. SIs were thus conceived as a means to execute block trades bilaterally. They were subject to less transparency requirement to avoid the risk of markets moving against the seller that would be exposed to risk. However, what was intended as a service to a specific segment of the market could very well become the main type of European trading platform should the current regulatory framework remain unchanged since SIs are given considerable advantages compared to trading venues.

Ahead of application of MiFID II/MiFIR, market participants and policy makers raised concerns that a series of loopholes in the Level 1 framework would allow SIs to become the path of least resistance for activity that has up until now been executed on dark pools or broker crossing networks. Left unaddressed, these loopholes would have resulted in a fundamental change of market structure away from public, transparent, and multilateral markets to private, opaque, and bilateral liquidity pools, which would have been completely at odds with MiFID II's objectives. FESE therefore strongly supports initiatives by the Commission and ESMA to close these loopholes, including the Commission Delegated Regulation on Article 16a which deals with 'external' riskless trading, and ESMA's Q&As on tick size and post-trade transparency requirements.

Under MiFID I, a very small number of SIs were registered in Europe. In comparison, the ESMA database[2] published in January 2018 combined with data from the UK FCA online register[3], show that more than 50 SIs have already been registered in Europe. Moreover, it is important to note that investment firms are not formally required to register as SIs until September 2018 when a first assessment of their trading will take place. Therefore, notwithstanding the already exponential increase in the number of SIs, the number will most likely increase further.

The increase in the number of SIs has been long expected but the development **underlines the importance of ensuring that the regulatory framework applicable to SIs works as intended by the legislator and that the SI regime does not undermine transparent regulated trading venues** by creating conditions for an inexorable further shift to dark trading.

Very early indications appear to validate the market's assumptions that volumes on SIs would grow considerably under MiFID II. Analysis by the **Tabb Forum**[4] shows that **SIs accounted for 17.6%** of total equity volume on 3 and 4 January, compared with just over 1% throughout all of 2017.

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011PC0656&from=EN
[2] https://www.esma.europa.eu/databases-library/registers-and-data
[3] https://register.fca.org.uk/
[4] http://tabbforum.com/opinions/mifid-ii-5-things-we-learned-about-equities-trading-in-the-first-few-days

Why it is important to address price improvement provisions

FESE strongly supported the ESMA Q&A on market structure published on 3 October 2017 that clarifies that SIs are bound by minimum tick sizes when offering price improvement up to SMS.

In publishing this Q&A, ESMA rightly recognised that "**marginal price improvements on quoted prices would challenge the efficient valuation of equity instruments without bringing any real benefits to investors**". FESE considers that the current Level 2 proposal, building on the Q&A, is very welcome, as it would promote legal clarity and consistent application of MiFID II/MiFIR throughout the EU.

Restricting an SI's capacity to price improve to meaningful price increments only, i.e. of at least one tick compared to the best bid and offer on the reference venue, will help to **ensure that SIs and multilateral trading venues are on an equal footing.**

As noted by ESMA in paragraphs 7-10 of the consultation paper, without these clarifications, meaningless price improvement that SIs would be tempted to offer would drive **significant trading flows towards them, following MIFID II's best execution requirements for investment firms**. This trend would be accentuated by the extensive use of smart order routers, which have the ability to 'ping' multiple venues and SIs for prices and will always give priority to - even marginally - better prices.

In the same context, FESE also welcomes ESMA's second Q&A from 3 October 2017, that clarifies that trading venues and SIs using similar technology and systems should process transactions for post-trade publication at the same speed. In the absence of such a clarification, control over the timing of trade publication on SIs (up to 1 minute) would have given firms (particularly market makers) operating SIs a considerable advantage over market makers on public markets. Moreover, it would also have given market makers further incentives to set up as SIs instead of providing liquidity on public markets, with potentially significant consequences on overall liquidity and market quality.

Amend MiFID II's Level 1 Framework to Extend the Tick Size Regime to SIs

However, while the clarifications above are essential to ensure that meaningless price improvement does not undermine the efficient pricing of traded instruments, **it is regrettable that they only apply to liquid instruments and up to SMS.**

Ultimately, while the ESMA proposal to amend RTS 1 is a step in the right direction, the market above SMS is still open to the risk of tick size arbitrage by SIs.

FESE is therefore supportive of calls for an amendment to the Level 1 framework, in order to extend the minimum tick size regime to SI trading in all sizes. In so doing, we share the concerns and policy objectives of the European Parliament which, we understand, has also called on the European Commission to make such a change. Moreover, we understand that this concern and objective is shared across a significant number of Member States.

In line with the views of those policymakers and regulators, **we consider that there is no policy reason to limit the application of minimum tick sizes to SI orders and quotes up to SMS only**, considering that on multilateral markets, the tick size regime applies to all sizes regardless of whether orders and quotes are transparent and the application of tick sizes to dark orders can and will be monitored via the trading venues' rules and order record keeping requirements. Extending the tick size regime to SI trading in all sizes is thus necessary to level the playing field and promote a transparent European market structure, as intended by MiFID II/MiFIR.

Implement a Short-Term Fix Via a Further Level 2 Change to the SMS Methodology

In advance of such Level 1 changes being agreed upon and implemented, **FESE believes it would also be worth exploring additional interim solutions within the Level 2 framework which could be applied relatively quickly.**

Such an approach could involve a **small revision to the methodology for the SMS calculation included in Article 11(3) of RTS 1** with a view to increasing the level and thus covering larger orders. In this context, it is important to note discrepancies across asset classes, with the SSTI thresholds framing the SI quoting obligation in respect of equity derivatives set at 75% of the relevant LIS threshold. This is clearly significantly higher than the levels at which SI are required to quote in respect of equities.

While SI quoting obligations are more demanding for equities and justify higher levels of protection in a bilateral, non-anonymous environment, **equities markets are also more liquid and could accommodate higher SMS levels.**

In assessing Article 11(3) of RTS 1, FESE has noted a discrepancy in the basis for the calculation of SMS: while MiFIR Level 1 (Article 14(4)) establishes that the calculation of SMS should be based on **order value**, RTS 1 Article 11(3)(a) and (c) refer to **transactions**, producing by definition a lower SMS level. While an amendment of the Level 2 text to replace 'transactions' with orders / quotes could be an option, FESE appreciates that gathering data on OTC orders could be problematic.

As an alternative, FESE believes that a simple amendment to this article to **include post-trade LIS transactions** would result in higher average value of transactions figures and increase SMS levels overall. This amendment would also ensure that the SMS level is properly representative.

Article 11(3): "[..]
(a) it shall take into account transactions executed in the Union in respect of the financial instrument concerned whether executed on or outside a trading venue;

(b) it shall cover either the preceding calendar year or, where applicable, the period of the preceding calendar year during which the financial instrument was admitted to trading or traded on a trading venue and was not suspended from trading;

(c) it shall **include** ~~**exclude**~~ post-trade large-in-scale transactions as set out in Table 4 of Annex I.

Question 2: Do you agree with the drafting amendment described above?

Yes, FESE agrees with the drafting amendment.