FESE Views on the UK Wholesale Markets Review

Brussels, 24th September 2021

Introduction

FESE welcomes the opportunity to respond to the UK Wholesale Markets Review consultation. Open, competitive, and fair wholesale markets are a prerequisite for efficient capital markets.

We welcome some of the UK Treasury's reflections on maintaining high standards, addressing failures in market structure and market data, and embracing technological changes. We would suggest, however, broadening the scope of such reflections and giving prominence to transparency and price formation. The balance between dark trading (for example on SI, OTC, and on-venue trading under waivers from pre-trade transparency) and transparent trading should be framed appropriately by regulation. Dark venues may serve as useful execution venues at times.[1] However, they are potentially harmful to the quality of trading and the price formation process as trading in dark venues limits the information available for price formation and fragments the order flow.[2] A balance must be struck which preserves and strengthens transparency and the price formation process and acknowledges the role of dark trading.

In this context, equity trading data shows a dangerously low share of continuous limit order books (CLOB) while two-thirds of the market comes from the combined share of OTC and SI trading. This picture does not change significantly when filtering out non-addressable liquidity or EEA ISINs. While approved publication arrangement (APA) misreporting could explain part of these results, **the evidence points to issues around transparency, and consequently price formation**. This contradicts the objective of MiFID II/MiFIR to significantly improve transparency by bringing more trading to lit multilateral trading venues.

[1] At low levels, dark trading is not necessarily detrimental for market quality – see Carole Comerton-Forde and Talis J. Putniņš, "Dark Trading and Price Discovery," *Journal of Financial Economics* 118, no. 1 (October 1, 2015): 70–92, https://doi.org/10.1016/j.jfineco.2015.06.013; Thomas Johann et al., "Quasi-Dark Trading: The Effects of Banning Dark Pools in a World of Many Alternatives," *SAFE Working Paper Series*, 2019; Haoxiang Zhu et al., "Do Dark Pools Harm Price Discovery?," 2012.

[2] 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). Dark venues may even have welfare consequences for the economy, see Zhu et al., "Do Dark Pools Harm Price Discovery?"

Figure 1: STOXX 600 Q1 2021 Turnover by venue jurisdiction and trade category (EUR billion)

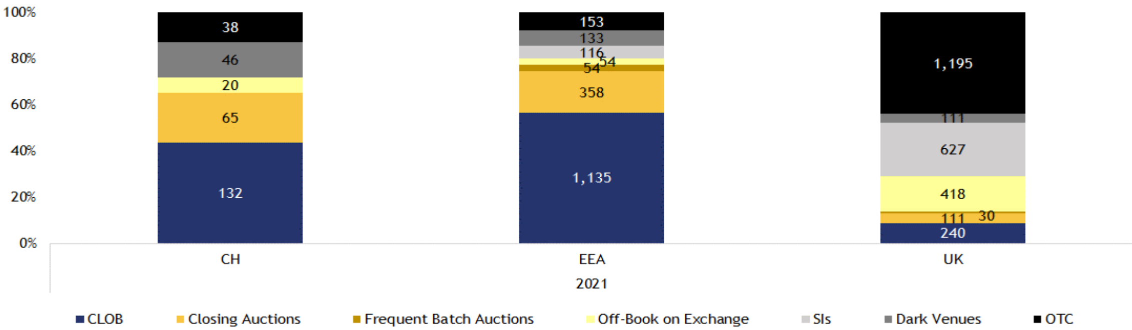


Figure 2: STOXX 600 Q1 2021 Turnover by venue jurisdiction, ISIN country code, and trade category (EUR billion)

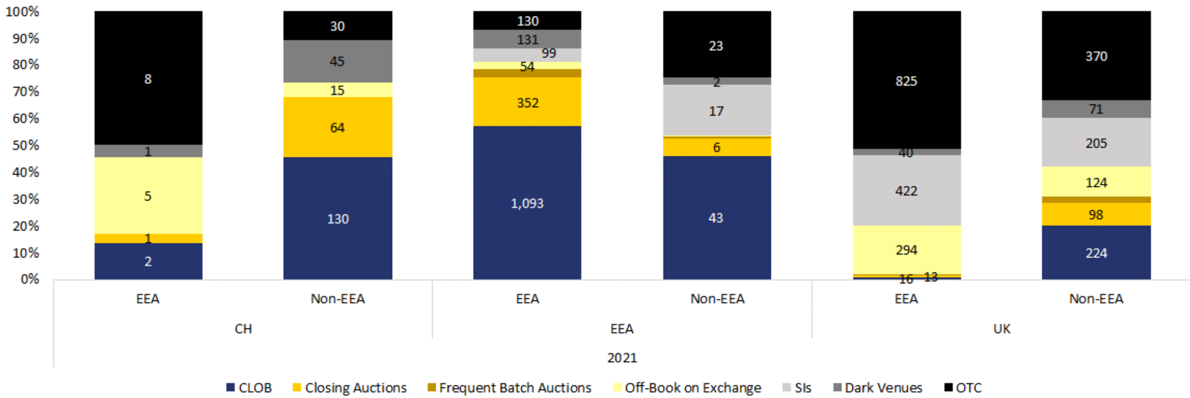
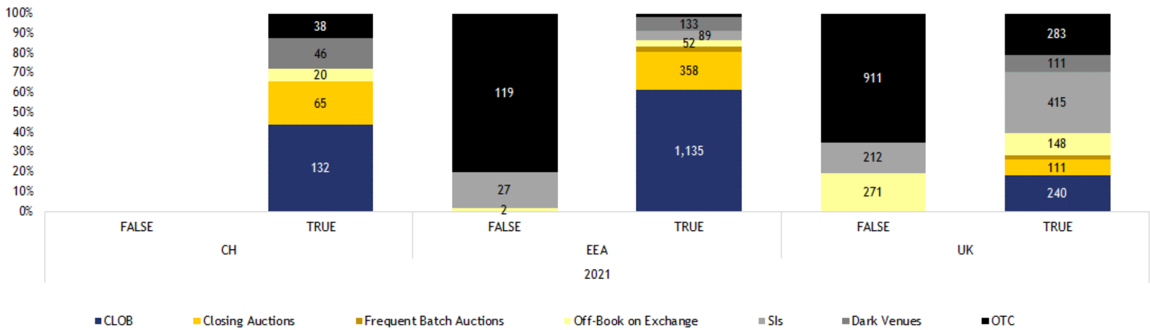


Figure 3: STOXX 600 Q1 2021 Turnover by venue jurisdiction, addressable liquidity (TRUE), and trade category (EUR billion)



Source: Big xyt, FESE calculations

In assessing these issues, it is also important to adopt a comprehensive approach and recognise that poor data quality in systematic internaliser (SI) and OTC trade reporting undermines a complete understanding of market structure and prevents reliable consolidation of data.

In this document, FESE outlines its views on the major aspects delineated in the UK Treasury consultation. Ultimately, we believe that a well-functioning price formation process is key to the stability and resilience of capital markets and has a positive impact on the cost of capital for the broader economy. We hope our reflections are useful and look forward to the UK Treasury reviewing our response.

Pre-trade transparency

Equity Markets

A simplified market structure would strengthen lit markets, support active price formation, and generate robust reference prices. More than two years after the implementation of MiFID II/R, transparency has not improved, while off-exchange trading has grown and SI and OTC trading have proliferated, harming liquidity sourcing and favouring limited pre-trade transparency and price referencing solutions. Against this backdrop, **FESE suggests restricting trading in SIs to above (or at least up to a percentage of) large in scale (LIS) for equity and equity-like instruments in order to preserve the price formation process, all the while acknowledging the need for bilateral trading**. Standard orders below (or up to a certain percentage of) LIS would exclusively be executed on trading venues, subject to full transparency requirements and contributing to efficient price formation. In this scenario, trading above (or at least up to a percentage of) LIS would constitute a legitimate dark space for the execution of larger order sizes.

Our proposal aims at simplifying the fragmented trading landscape, as below LIS trades should contribute to price formation given the limited market impact. This type of trading should operate in a trading venue, under non-discretionary and non-discriminatory rules, and comply with the tick size and transparency regimes. In general, there is a need to further SIs transparency and reporting obligations so that investors and regulators can verify best execution claims.

FESE does not agree with the UK Treasury proposal to delete the double volume cap (DVC) without the introduction of an alternative measure to limit dark trading , At the same time, we acknowledge that there is a need to address the concerns of institutional investors in the middle ground between retail size orders and the LIS market. Alongside ensuring price discovery, the interests of these stakeholders could be served by considering a broader range of market models in this space or lowering the relevant threshold above which transparency is waived for large transactions.

FESE does not agree with the UK Treasury proposal that reference price systems should be able to match orders at the midpoint within the current bid and offer of any UK or non-UK trading venue offering the best bid or offer. The intrinsic connection of the most liquid markets with the creation of reference prices owes to their robust mechanisms which ensure transparent, orderly and non-discriminatory trading and price efficiency. **Reference prices are referenced because they are representative of the market value of instruments, which is why most market structure models refer to only one reference price underpinned by the primary best bid and offer.** This is entirely consistent with order flow competition: under MiFID II/MiFIR, pre-trade transparent venues, both regulated markets and multilateral trading facilities, can be the most relevant market in terms of liquidity and generate the reference price.

Non-equity markets

In bonds and securitised derivatives markets trading is still opaque and there was no increase in transparency triggered by MiFID II compared to MiFID I. This is especially the case for SI trading where there is seemingly no pre- and post-trade transparency available. Transparency on SI quotes (and prices) in bonds and securitised derivatives is established by SIs via proprietary means, via their websites, via ECN-like networks or has not to be established at all (for illiquid bonds). This conflicts with the aim of increasing transparency in the traditionally opaque markets in these instruments. **On these markets, we would recommend using the 100,000 EUR denomination threshold to delineate lit (RM, MTF and OTF) trading from dark (OTC and SI) trading.** Limiting trading at and below the 100,000

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EUR threshold to transparent multilateral venues would reduce market fragmentation and increase liquidity and pre- and post-trade transparency, in particular for retail investors.

With respect to the ETD markets, we believe that the proportion of lit trading should be increased while preserving the needs of market participants for pre-arranged transactions based on an analysis of the instruments' liquidity. However, **for certain ETD products or sub-asset classes, the current LIS thresholds have detrimentally impacted the liquidity of these products.** In the respective products, higher thresholds for off-book on-exchange trading, compared to pre-MiFID II conditions, have moved trading volumes away from exchanges and into the OTC market. Therefore, the recalibration of LIS thresholds for ETDs should address in particular the launch of new products on trading venues, and the time and measures needed to establish exchange trading as a viable alternative to the OTC market, where these or similar products might currently be traded.

Furthermore, we believe that **the pre-trade transparency regime needs to be simplified and made more coherent for the market**. Therefore, we suggest removing the SSTI waiver, recalibrating the methodology used to determine LIS thresholds, where appropriate, and reducing thresholds in some asset classes to make them fit for purpose, e.g. for commodity derivatives and bonds. In addition, we believe a tailored approach finetuning - possibly lowering - the current threshold could be investigated for some ETDs.

These measures should be accompanied by also removing the SSTI-concept for the SI-quoting obligation and replacing it by a reference to (a high percentage of) the LIS threshold.

With regards to commodity markets, the current pre-trade regime is not appropriately calibrated. The methodology for calculating the Illiquid Instrument ('IL') waiver and Large in Scale ('LIS') waiver needs to be revisited or abandoned as it currently does not reflect market reality. Prior to its replacement with the MiFIR process, exchanges actively managed the process of setting LIS thresholds, overseen by their regulator, to ensure that the right balance was struck. Market participants were also able to feed into the process, thus ensuring that all stakeholders could contribute to achieving an appropriate balance. FESE therefore recommends reinstating this approach, which worked well for 20 years prior to its replacement with the flawed MiFIR process.

Lastly, it is important that the liquidity calculations are also reviewed so that bonds that actively trade fall within the scope of the transparency requirements. This should improve the level of pre-trade transparency available to the benefit of investors and the market in general.

Liquidity calculations

The number of bonds currently classified as liquid shows that the liquidity determination process is not delivering. We believe that the limited number of liquid bonds can be attributable to (i) criteria that have been incorrectly defined, (ii) numerical parameters that are not appropriate, or (iii) inaccurate or incomplete reporting from market stakeholders.

We have identified a series of proposals that could help amend the current methodology. In the medium-term, these include running simulations with different transparency thresholds to understand better their impact, performing a full assessment of the underlying data - and adjusting the data when required (before running new transparency calculations). In the longer-term, we would suggest performing the liquidity assessment by using a different liquidity measure, such as the issuance size parametrised for each bond type.

With regards to ETDs, for certain products or sub-asset classes, the current LIS thresholds have detrimentally impacted their liquidity. **The LIS thresholds for ETDs should be recalibrated to address in particular the launch of new products on trading venues, and the time and measures needed to establish exchange trading as a viable alternative to the OTC market.**

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Overall, **we support the UK Treasury proposal to move away from regular liquidity calculations towards a mix of qualitative and quantitative criteria.**

Post-trade transparency

Post-trade deferrals should be harmonised and OTC, SI and venue data should reach the same level of quality in post-trade reporting.

Specifically for non-equities, **FESE agrees with the UK Treasury's intention to delete the SSTI-waiver and to simplify the post-trade transparency framework.** We are of the view that only a fraction of all non-equity transactions should be eligible for deferred publication, i.e. for bonds, the illiquid and LIS deferrals should be maintained. For ETDs, package order waivers could potentially be maintained as well, but this should be further assessed in line with future market developments. **We suggest reducing the complexity of the current framework by only allowing one timeframe for deferred publication, irrespective of which waiver is used.** Deferral periods of up to four weeks immensely decrease the value of the respective data for market participants, as the data becomes outdated and thus irrelevant. For derivatives, we support a harmonised and simplified deferral regime, requiring the publication of all transaction-related data by the next business day (and no later than t+2). Furthermore, OTC look-alike contracts should not be eligible for deferrals. Lastly, we would support timely publication of post-trade transparency data, i.e. within 15 minutes currently, 5 minutes in the future, across all asset classes to enhance competition among market participants, reduce asymmetries of information and deliver high quality information for market users.

Overall, it is important to ensure that CCP-cleared multilateral trading is incentivised as much as possible, as this provides the most scope for effective price formation and offers anonymity which aids market confidence. However, markets in various assets are at differing stages of evolution. The regulatory framework should allow various forms of trading to be licenced within the regulated perimeter while allowing for its migration towards a multilateral model which we believe is best for market development.

Perimeter of trading venues and SIs

FESE believes that there is merit in fostering a uniform understanding of the differentiation of multilateral and bilateral systems. **To level the playing field, we would like the introduction of an authorisation procedure for SIs. Further, regulatory authorities should carefully monitor if systems registered as bilateral systems operate as such and do not engage in any multilateral activities.** While SIs are regulated under MiFID II/MiFIR as execution venues providing bilateral trading, they provide less transparency than on-venue trading. This can be problematic when the distinction between purely bilateral and hybrid multilateral trading is blurred. The same scrutiny should apply to operators of multilateral systems. Should the authorities come to the conclusion that a clear identification of bilateral systems is not possible, they might want to consider introducing a definition of bilateral activities into the legal framework to clearly differentiate them from multilateral systems.

FESE generally agrees with the intention of the UK Treasury to clarify the regulatory perimeter for trading venues. However, **some of the proposals, such as those basing the definition of SIs on qualitative criteria or allowing SIs to execute at the midpoint for all trades, are ill-suited for this purpose.**

Share trading obligation

The STO remains necessary and is an important element in ensuring and enhancing the efficiency, resilience and integrity of financial markets. The obligation of investment firms

to ensure that the trades they undertake in shares admitted to trading on a regulated market, or traded on a trading venue, take place on a regulated market, MTF, SI, or an equivalent third-country trading venue is fundamental for capital markets.

However, for the STO to be fully functional, further work is necessary to clearly determine which types of transactions should be exempted – namely, those that are non-systematic, ad-hoc, irregular and infrequent, or carried out between eligible and/or professional counterparties which do not contribute to the price discovery process. The approach should avoid undue complexity and be based on predictable and meaningful criteria.

Derivatives trading obligation

Any changes from key rules agreed by the G20 with a view to making our markets more stable and resilient should be based on a thorough impact assessment in order to avoid any unintended side effects.

Potential loopholes in the trading obligation under MiFIR and/or the interplay between the clearing rules under EMIR for OTC derivatives and under MiFIR for ETDs should be avoided as these would threaten to drive ETD volumes to OTC venues and to 'pure OTC' (contracts traded bilaterally, not on an MTF or OTF).

Consolidated tape

FESE believes that investors should be able to get a full overview of the market and know where their orders are executed. However, full data consolidation is not yet available, especially when it comes to SI and OTC data. **In order to enable full data consolidation, steps should be taken to remedy at source incomplete or inaccurate reporting of SI and OTC trades**, including clear regulatory rules as to who reports when and what. Reasons for bad quality data are rooted in various factors, such as in static reference data which may wrongly classify instruments, misunderstandings between the reporting parties as regards which party to the trade finally reports (e.g. sometimes it may be unclear who is the SI for the instrument in question), and so on. Furthermore, it is worth noting that in practice, interested firms do not necessarily approach each data source separately in order to obtain a consolidated view. At least in the context of equities markets, regulated markets and MTFs data is already consolidated and broadly available across data consolidators and vendors. As such a CT that would not provide for full coverage of all execution venues would be deprived of practical significance given that solutions such as these already exist today.

Provided that data quality issues are solved, a Tape of Record (ToR), a CT that would disseminate post-trade data after the market close, covering all venues and execution mechanisms, would deliver a true consolidated view of the market. A ToR would represent a cost-effective and simple solution, without the latency and arbitrage issues of a pre-trade CT, and meet the needs of market participants. A ToR would allow for execution quality analysis, transaction cost analysis (e.g. price slippage), and compliance analysis while avoiding high costs for the industry as a whole without tangible benefits. As such, a ToR would provide valuable insights into trading and would represent a more cost-effective approach than an "as close to real-time tape". Comparable industry solutions already exist, demonstrating that the ToR is a viable solution that has fewer latency, risks, and complexity issues, all the while being able to deliver clear value to the market.

In this context, FESE believes that **regulatory authorities should be actively involved in creating a CT for two main reasons: establishing a solid revenue model redistributing revenue to data contributors and a strong neutral governance framework.**

One of the UK Treasury proposals is to remove the requirement for CTs to provide 100% coverage of equity trading activity or 80% coverage of fixed income. We disagree with

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this assessment and would underline that 100% view of the market is critical for the CT to have added value. A CT that would not provide for full coverage of execution venues would be deprived of practical significance. Market data on lit trading venues is widely available to market participants through direct feeds, vendor terminals, and trading venues' websites. The real benefit of a CT would reside in the consolidation of OTC and SI data which is currently hard to access. While data vendors allow market participants to consume data from all trading venues through a single access point, SI and OTC data remains scattered and fragmented often due to a lower level of data quality. A CT would therefore only improve on current levels of transparency, and have a shot at offering a complete consolidated view of the market, if it covered 100% of data sources. In addition, as observed above, in order to enable consolidation, steps should be taken to remedy inconsistent reporting of SI and OTC trades. Correct, reliable and consistent flagging of transactions as well as timeliness, accuracy and completeness of the data is key to allow for consolidation in the first place. A CT will only be as accurate and reliable as the data coming from the worst performer contributing to it. As such, addressing data quality issues is a prerequisite. In any case, policymakers should ensure that the market structure is fit for purpose, i.e. promote overall transparency in financial markets. A CT is not to be seen as a substitute for an adequate market structure.

FESE would also caution against an approach including multiple competing CTs, an aspect explored by the UK Treasury in its consultation paper. In the current landscape, multiple competing CTs would clearly not be in a position to solve data quality, reliability, and consistency issues downstream which originate from inconsistent trade reporting behaviour at the source. Also, we would question the potential viability of multiple competing CTs and the capacity of private-sector CTs to ensure that an appropriate governance and remuneration framework is in place to fairly compensate data providers contributing data to the CT.

Commodity markets

We strongly welcome the amendments to the position limits regime which were introduced via the recent EU MiFID 'quick fix'. The new regime will deliver a more proportionate and efficient regime which would allow new and nascent products to develop but would also deliver transparency in commodity markets and address excessive commodity price volatility. While this direction of travel already goes beyond the current UK regime and reflects the inadequacy of position limits, **FESE would encourage HM Treasury to go beyond this and shift to a more dynamic and market-led method by reverting to a position management approach.**

Commodity derivatives are global products that are traded in a highly competitive environment, and it is therefore crucial that jurisdictions which host such markets tailor their regime to meet the needs of international customers while ensuring high regulatory standards that focus on outcomes. In this regard, FESE strongly supports a more dynamic approach which would see the transfer of responsibility away from the FCA setting fixed position limits to trading venues having increased responsibility for setting controls to ensure orderly trading, settlement and delivery. Trading venues are best placed to conduct these tasks and have operated sophisticated position management regimes since before the MiFID II entry into force.

FESE welcomes HM Treasury's proposal to review the position limits regime under UK MIFID II to ensure a more proportionate regulatory regime is in place. **FESE agrees with paragraph 6.9 of the Consultation, which sets out that the pre-MIFID II approach whereby trading venues exercised judgment regarding the implementation of controls and various forms of position limits was a successful approach delivering the right outcomes**. FESE is therefore of the view that no contracts should automatically be subject to rigid position

limits set by the FCA and instead trading venues should be responsible for managing positions.

Lastly, **in line with the UK Treasury proposal, we would support a position limit exemption for financial counterparties under mandatory liquidity provision obligations.** Furthermore, **such an exemption should not be limited only to financial counterparties but also expanded to non-financial counterparties**, as in many cases, non-financial counterparties fulfil mandatory liquidity obligations as well.

SME markets

FESE agrees with the UK Treasury that some of the regulatory requirements for disclosure at admission to trading could be amended to ensure they are proportionate, especially for small-sized issuers. In respect of the SME Growth Markets (SME GMs) regime, FESE considers that the 2019 EU changes to the Market Abuse and Prospectus Regulations and MiFID II delegated regulation were a step in the right direction. The revision of the prospectus rules was a very important step to reduce costs and burdens for companies whilst improving their access to financing. We especially welcome the amendment that allows issuers listed on SME GM for at least two years, who intend to transfer quotations to the regulated market, only to have to produce a simplified prospectus. This will be very beneficial for smaller companies, in the earlier stages of growth, that are more dependent on local investors for financing.

Cross-cutting issues

Digital finance

We believe that **the principles of technology neutrality and "same business, same risks, same rules" are essential to upholding the values of transparency, fairness, stability, investor protection, and market integrity**.

With regard to technology neutrality, FESE would caution against overly prescriptive technological measures which would rapidly become outdated due to technological evolution and would risk hindering enterprise innovation. It is important to ensure that the sectoral regulation and the supervisory system cover new financial services players and are applied consistently to all actors seeking to compete and innovate in digital finance. **Creating a level playing field is essential not only in terms of fair competition but also in terms of investor protection.**

Sustainable finance

Climate change is a global problem and needs a consistent global response. In particular, we should increase dialogue at the global level on non-financial reporting standards to ensure consistency and avoid putting UK and EU companies in a less favourable competitive position. The UK and EU should take a leading role in the development of comparable international standards, which should embrace the concept of double materiality and, to the maximum extent possible, stem from the convergence of existing standards.

FESE sees merit in working towards a global approach on the sustainable finance Taxonomy, which would ultimately require a confluence of "green definitions". In this context, we would support the UK Green Technical Advisory Group taking the EU Taxonomy as the main reference for its work, with the resulting UK Green Taxonomy not differing substantially from its EU counterpart.

FESE would recommend regulators have an inclusive approach, targeting transition and not only steering investments to already green activities. To drive the transition, it is important that companies' best efforts are recognised and that companies that are

implementing changes to become ESG compliant are not excluded from related initiatives or funding opportunities. In this regard, the European Commission has suggested extending the EU Taxonomy framework to better recognise these transition efforts and mobilise investments for intermediary steps on a credible pathway towards sustainability. The UK Green Technical Advisory Group could join the EU in its efforts in order to adopt a convergent approach to the Taxonomy.

We should promote a more inclusive sustainable finance framework that provides SMEs with more financing opportunities and encourages retail investors' participation in capital markets. FESE supports the introduction of specific incentives, such as tax relief, to facilitate access to finance for SMEs engaged in sustainable activities, or for those SMEs wishing to transition. Tax incentives for issuers of and investors in green instruments, such as green bonds, would also trigger an increase in their supply and demand.

It is important to keep in mind that financial markets reflect developments in other parts of the economy and the sustainable finance agenda cannot, by itself, realise the goals of the Paris Agreement. In particular, a transparent and consistent approach, in line with ESG aspects, by the real economy, financial industry and regulators holds great opportunities for European capital markets. Real change can be achieved by adopting sector-specific regulations and tax incentives to promote the fight against climate change.

Retail investment

We believe that **retail investors should be empowered by making investment practices simpler, cheaper and more transparent, and by improving access to simple and cost-efficient products, while taking steps to prevent conflicts of interest and ensure investor protection.**

Open finance could provide a number of opportunities for consumers, such as gaining access to a wider range of financial products. As open finance becomes available to third-party providers, it could also benefit businesses, both traditional financial institutions and FinTechs, and IT companies. However, opening data to third parties could also pose risks for customers in terms of security and data protection. Thus, ensuring investor protection against cyberattacks, customer data misuse or leakage is key and this could be achieved by establishing trusted data intermediaries.

With regards to social media platforms, we believe that while information is easily accessible on such platforms, its reliability cannot be ensured. In this respect, it is important to urge retail investors to exercise extreme caution when making investment decisions based solely on information from social media and other unregulated online platforms. Concerning online brokerage platforms providing commission-free services, they might at first glance provide cheap brokerage services, but their business model is often based on payment for order flow (PFOF), which constitutes a conflict of interest between their duties to their clients and to third parties. FESE therefore supports the FCA's decision to ban PFOF. While the new appetite of retail investors for stock market investing is an important and positive trend to be strongly supported, it is important to strike the right balance. To ensure the long-term participation of retail investors alongside professional investors, a high degree of confidence in financial markets and a proper trading environment are vital.

Overall, retail investors need a market architecture that works for everyone, provides efficient price formation, fair competition and interaction among market participants, and renders best execution. Trading venues are well-suited to deliver on these 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.

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About FESE

The Federation of European Securities Exchanges (FESE) represents 36 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 August 2021, FESE members had 9,316 companies listed on their markets, of which 13% 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; 1,341 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.