

FESE Paper on the Evolution of EU Equity Market Structure

Thursday 30th July 2020

Thirty months after the implementation of MiFID II, it is clear that policymakers' ambition to increase equity trading transparency by bringing more flow to lit venues has not been realised. This is to the detriment of end-investors and issuers. The data in Figure 1 shows a decrease of lit venue traded volumes, with the Central Limit Order Book (CLOB) share of trading (STOXX 600) decreasing to 33% in June 2020, down from 41% in January 2018. During the same period, Systematic Internalisers have become a significant player, OTC trading has increased and frequent batch auctions have emerged: these alternative venues offer reduced transparency compared to lit markets and, as demonstrated during the recent Covid-19 related volatility, less robust frameworks for transparent price formation.

As a contribution to the preparation of the MiFID II Review, FESE has been providing analysis illustrating the need for a simplification of equity market structures to improve data quality and overall transparency. Furthermore, lit markets have once again acted as a safe-haven during the Covid-19 crisis. The increase in lit trading observed in times of market turmoil, illustrated in Figure 2 below, and the subsequent reversal of this trend show that there is a real need for fair and transparent markets and raises serious questions regarding the nature of the price formation offered by alternative venues. Overall, this highlights the importance of addressing the fundamental flaws of the current equity market structure.

In assessing these trends, it is important to adopt a comprehensive approach while reflecting on the structural impact for all relevant liquidity types. In so doing, it is important to recognise that poor data quality in SI and OTC trade reporting prevents market participants and regulators from understanding where, and under what specific conditions, executions can and should take place on these venues. Trade reporting therefore needs to be aligned via a consistent implementation of the Market Model Typology (MMT). Calls for a potentially generalised exclusion of "non-addressable" liquidity from the data appear premature at this stage, given the ongoing issues with data quality and the fact that the concept is not clearly defined in MiFID II. Instead, we suggest that regulators conduct a thorough assessment of the topic, focusing on SI and OTC trading eligibility, to provide a basis for potential amendments to the legislative framework.

In assessing the impact of MiFID II and potential amendments it is important not to see this debate as 'exchanges' versus 'investment firms'. This debate is about:

- Delivering on end-investor needs: as markets are becoming more complex to navigate, it is time to go back to a simpler and more transparent market structure.
- The overall public interest of ensuring an efficient price formation process underpinned by the resilience lit markets have demonstrated in the recent crisis.

In reviewing MiFID II and as an integral part of the work on bringing the Capital Markets Union to life, policymakers and regulators should enable an equity market structure that caters to these objectives through:

- A simplification of market models that supports active price formation and the generation of robust reference prices.
- More inclusive markets, facilitating and encouraging direct access for pan-European, national and local banks.
- An enhanced offer to investors (big or small, retail or institutional) of better ways of interacting with transparent markets.

Material simplification of market models can be achieved by limiting SI trading in equities to above Large-in-Scale (LIS) only. This would be accompanied by the removal of the Reference Price and Negotiated Trade Waivers which would negate the need to retain the DVC. Standard

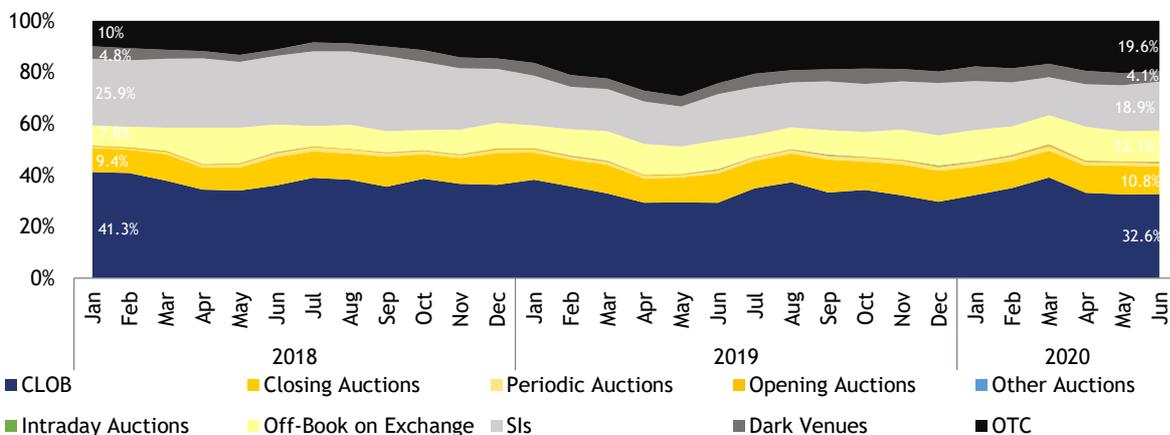
orders below LIS would exclusively be priced on Regulated Markets and MTFs, subject to full transparency requirements and contributing to efficient price formation. In this scenario, trading above LIS would constitute a legitimate dark space for the execution of larger order sizes. In defining lit vs dark, there is also a need to address the valid concerns of institutional investors in the middle ground between small sized market execution size and LIS orders.

FESE Members are developing a range of structural initiatives to contribute to market simplification, facilitating access to transparent markets. We look forward to making a contribution to the ongoing regulatory and policymaking discussion on market structure issues in parallel.

Annex: A snapshot of the trading landscape under MiFID II/MiFIR

MiFID II did not bring additional volumes to lit venues and instead resulted in a drop in the market share of CLOB. Traded volume on lit venues during the continuous trading session has seen a significant decrease since January 2018. Taken as a percentage of the turnover across venues, the market share of CLOBs has decreased, from 41% to 33% in thirty months (Figure 1).

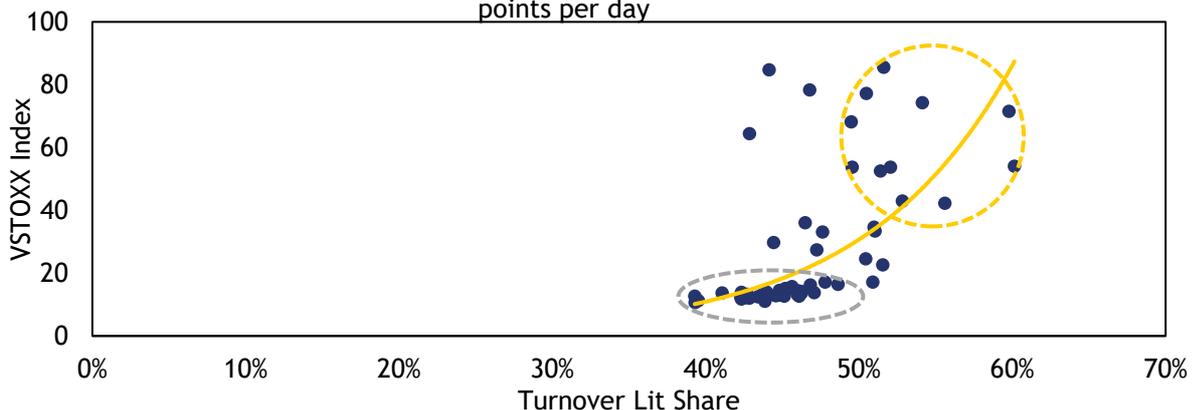
Figure 1: STOXX 600 Market Share by execution mechanism



Source: Big xyt data, FESE calculations

However, while the lit market share was following a downtrend, during the Covid-19 crisis with an environment of heightened volatility and turnover, the share of lit trading increased substantially. As other highly regulated entities, Regulated Markets are obliged and committed to being operationally resilient. The share of lit trading compared to volatility illustrates this resilience. Figure 2 shows how the crisis gave rise to a new setting; high volatility and lit share (yellow circle). The March 2020 spike in volatility measured by VSTOXX Index, an implied volatility benchmark followed a similar increase in turnover by about a week. Overall, the recent Covid-19 related volatility demonstrates that alternative venues offer less robust frameworks for transparent price formation compared to lit markets. This proves the importance of lit markets and the necessity to ensure they function efficiently at all times.

Figure 2: European Lit Share and Volatility during the COVID-19 Crisis, points per day



Source: Big xyt, FESE calculations