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Client Alert Commentary

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Key Takeaways from ESMA's recent MiFID Transparency Consultation Papers

ESMA's consultation papers on MiFID non-equities SI and equities transparency regimes propose important changes.

Key Points:

- ESMA's recent consultation papers on the MiFID transparency regime raise queries and make observations in respect of a number of issues that firms grappled with in the run up to implementation.
- The proposals would simplify the regimes with the consequence of — primarily for equities — increasing the levels of pre-trade transparency provided by firms and trading venues across instrument classes.

MiFID requires ESMA to submit a report to the European Parliament and Council on the functioning of the transparency regime for trading venues (due July 2020). As part of this work, ESMA published two consultation papers (CPs) on: (i) the equities transparency regime, including the double volume cap (DVC) mechanism and mandatory share trading obligation; and (ii) the application of pre-trade transparency obligations to systematic internalisers (SIs) in non-equity instruments.

Responses to (i) are due on 17 March 2020 and to (ii) on 18 March 2020. ESMA is due to publish a further CP on the non-equities transparency regime in the next few weeks.

ESMA states that the CPs contain proposals that attempt to strike a balance between simplifying the transparency regime and improving the overall transparency available to market participants. This *Client Alert* considers the key changes proposed for firms and trading venues in both CPs.

Equities Transparency CP

Equities Transparency — ESMA's Observations

Pre- and post-trade transparency requirements for shares were introduced by MiFID I. MiFID II aligned the transparency rules applicable to trading venues and multilateral trading facilities, and expanded the scope of the obligation to equity-like instruments (*i.e.*, depositary receipts, exchange traded funds, certificates, and other similar financial instruments).

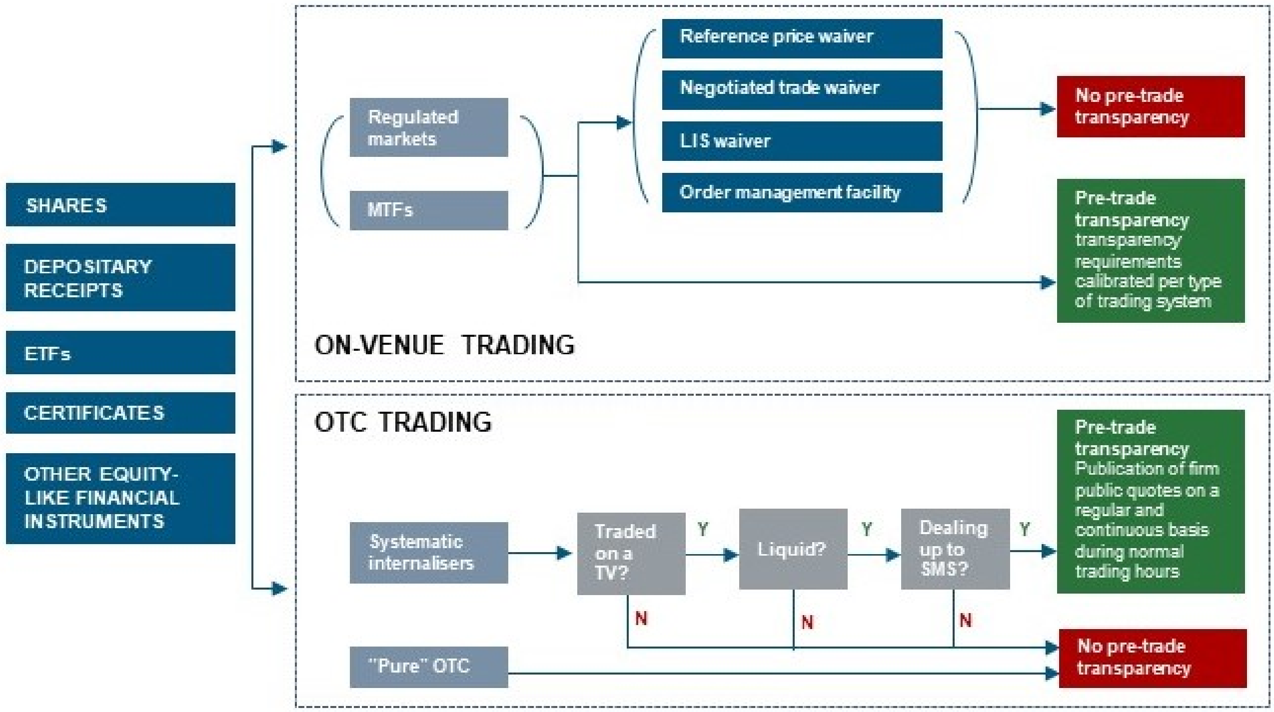

Diagram illustrating the pre-trade transparency regime in equity and equity-like financial instruments (extract from p. 12 of ESMA's CP on equities transparency).

The CP sets out detailed technical analysis, by asset class, on the levels of pre-trade transparency provided following "go live". Whilst ESMA concludes that transparency levels have increased, it observes that:

- The increase relates to instruments that were previously outside the scope of MiFID I, but the overall objective of the regime — to promote market transparency and a robust price formation process — has not been achieved.
- Despite the trading obligation for shares, a large portion of transactions are still executed OTC.
- There is still a great deal of reliance on the waivers and, in particular, a shift to the large-in-scale (LIS) waiver. ESMA attributes this to the introduction of the DVC (see *Equities Transparency — Double Volume Cap* below for further detail on the DVC) — although this was widely predicted by the market pre-implementation.

These observations drive ESMA's key proposals. Note that ESMA acknowledges that some of the proposals in the CP would not be compatible with other proposals (for example, if the reference price and negotiated trade waivers are removed, the DVC and any proposed amendments would no longer be relevant). However, ESMA states that the primary purpose of the CP is to prompt an open discussion on all possible approaches, before crystallising any policy proposals.

Equities Venue Transparency — Waivers

ESMA's view is that the pre-trade transparency waivers are being overused and that they should be "*the exception and not the norm*", and so proposes that the waivers should be used in isolation and not in combination, as is current practice.

ESMA also suggests removing the reference price (RP) and negotiated trade (NT) waivers for liquid and illiquid instruments (but not the waiver for negotiated trades subject to conditions other than the current market price). The rationale is that these waivers harm price formation, encourage dark trading, and do not have a clear policy objective, unlike some of the other waivers, which: (i) protect market participants from adverse market movements, or (ii) allow the execution of technical trades where the disclosure of information would not be of use to other market participants. Alternatively, ESMA suggests allowing the RP and NT waivers only for orders above a certain size. However, this would only be meaningful if the threshold is set below current LIS thresholds.

ESMA also proposes amending MiFIR to ensure that any trading system that is considered to be non-price forming always benefits from a pre-trade transparency waiver (this includes issuing rules on what constitutes a price forming / non-price forming system).

Equities Transparency — Definition of Liquid Market

The definition of liquid market is relevant to a number of transparency obligations, namely: (i) to determine when SIs are subject to pre-trade transparency, and (ii) for the application of the different NT waivers and DVC.

ESMA proposes recalibrating its liquidity assessment, on the basis that the majority of equity and equity-like instruments are currently deemed to be illiquid and that this does not accurately reflect the market. ESMA is also looking to simplify its methods for testing liquidity by basing its assessments on data that is easier to retrieve. ESMA presents a number of different approaches based on asset class. A key proposal is that the assessment for shares should not take into account whether the instrument trades daily or should only require trading for a minimum percentage of days. ESMA also proposes removing the category of “certificates” from the equity-like transparency scope and deeming “other equity instruments” to be illiquid by default.

Equities Transparency — Double Volume Cap

The DVC limits the trading that occurs under the RP waiver and the NT waiver for liquid instruments (to ensure that the use of those waivers does not unduly harm price formation). The DVC limits the use of the RP and NT waivers in a financial instrument: (i) on a particular trading venue to 4% of the total trading in the EU over the previous 12 months (the Trading Venue Cap), and (ii) on all trading venues across the EU to 8% of the total trading in the EU over the previous 12 months (the EU-level Cap).

ESMA has concluded that the DVC has had positive effects for market liquidity, resulting in a decrease in the bid-ask spread and an increase in average trade size. However, ESMA considers that these benefits should be balanced against the complexity of the DVC mechanism. As such, ESMA is considering the following alternative options:

- Eliminating the Trading Venue Cap and maintaining the EU-level Cap
- Eliminating the Trading Venue Cap and reducing the EU-level Cap to 7%

ESMA suggests that lowering the EU-level Cap from 8% to 7% would reduce the amount of dark trading in the EU, as it would deter the markets from relying on the RP and NT waivers unnecessarily to avoid triggering a suspension. However, it is unclear whether this would be in the outcome, as market participants could (as ESMA indicates is currently the case) continue to rely on the waivers until the thresholds are breached.

Equities Transparency — Frequent Batch Auction (FBA) Systems

FBAs are a relatively new type of periodic auction trading system that started gaining traction following the introduction of the DVC. Auctions on FBA systems take place over a very short duration at certain points during the course of the day and are triggered by market participants. Orders are aggregated before and during the auction call without leading to a trade and, at a specific point in time, matched and executed at a single price. ESMA's view is that FBA systems share the characteristics of periodic auctions, but that the MiFID II requirements for periodic auction systems do not provide sufficient transparency when applied to FBAs (see ESMA's Opinion on FBAs, in which ESMA opines on how FBA systems should provide transparency). In the CP, ESMA proposes amending Commission Delegated Regulation (EU) 2017/587 (RTS 1) to draw a clear distinction between conventional auctions and FBA systems. ESMA suggests that FBAs should disclose all orders submitted to them.

Equities SI Transparency

The transparency regime applicable to SIs differs from that applicable to trading venues. SIs are only required to make public firm quotes in equity and equity-like instruments that are: (i) traded on a trading venue, (ii) deemed to be liquid, and (iii) below the standard market size (SMS). The minimum quote size for SIs is 10% of SMS. ESMA notes that these specificities mean that the majority of SI trades tend not to be subject to transparency, making SIs preferable to "lit" venues. To level the playing field, ESMA proposes increasing the minimum quoting size to 50% or 100% of SMS.

ESMA also proposes extending the regime to illiquid instruments to better align the SI obligation with that for trading venues. However, there are significant differences between the SI and venue regimes, notably that venues have a broad range of waivers available to them.

Share Trading Obligation (STO)

The STO requires investment firms to conclude transactions in shares that are admitted to trading on a regulated market or TOTV on EU venues, SIs, or an equivalent third-country venue. What constitutes an "equivalent" venue is likely to be hotly contested during Brexit negotiations, and in the event of a hard Brexit at the end of the transitional period, the UK and EU will operate mutually exclusive STOs. The lack of equivalence would pose problems for UK branches of EU firms (as well as EU branches of UK firms), as they would be subject to both the EU and UK STOs (as currently drafted, the UK STO could only be satisfied by concluding a transaction on a UK venue or SI). Liquidity would also be fragmented for any shares caught by both regimes. ESMA's comments in the CP indicate that it is trying to find a pragmatic approach that would limit the disruption to firms and, despite the proposal it puts forward, ESMA is continuing its search for suggestions on how to resolve the tension. Any resolutions that ESMA can achieve now are likely to limit the "Brexit battleground" in future.

ESMA acknowledges that its current proposal, which is based on whether an instrument has an EU or non-EU ISIN, is not sufficient because it does not address the problem of where the primary pool of liquidity resides, and suggests supplementing this approach by looking at whether an issuer has actively sought to have its shares admitted to trading on a non-EU trading venue (on the basis that it would then be reasonable to assume that the main pool of liquidity for that issuer's shares is located outside of the EU). The downside to this approach is that it would then become relatively easy for issuers to circumvent the EU STO by requesting admission to trading on non-EU venues. As such, some further qualitative assessment would be required in order to determine whether a share's primary liquidity pool is outside the EU (which has its own challenges, not least from a data quality/gathering perspective).

ESMA is also considering whether SIs should remain an eligible execution venue under the STO. The rationale for removing SIs would be to offer deeper pools of liquidity and reduce fragmentation (ESMA notes that post-MiFID II, the number of SIs increased from 10 to more than 70). This would undoubtedly have a significant impact on market structure, and runs contrary to ESMA's commentary on seeking to achieve a level playing field between trading venues and SIs.

ESMA is seeking views on whether the exemptions to the STO should be maintained. In particular, market participants have adopted diverging views on what constitutes a "*non-systematic, ad hoc, irregular and infrequent*" (and therefore exempt) transaction. At a minimum, ESMA proposes clarifying the scope of the exemption via a delegated regulation. Given ESMA's comments on the high volume of OTC trading in shares, ESMA is placing emphasis on policing the STO regime (see also *Equities Post-trade Transparency* below).

Equities Post-trade Transparency

ESMA states that, on the whole, it is "satisfied" with the levels of post-trade transparency being provided by trading venues and SIs. However, it proposes introducing a new post-trade transparency indicator that would flag when a transaction is not subject to the STO, but is subject to post-trade transparency. This would allow ESMA to better monitor adherence to the STO, since ESMA notes that it has not seen as significant a shift to venue/SI trading as it expected.

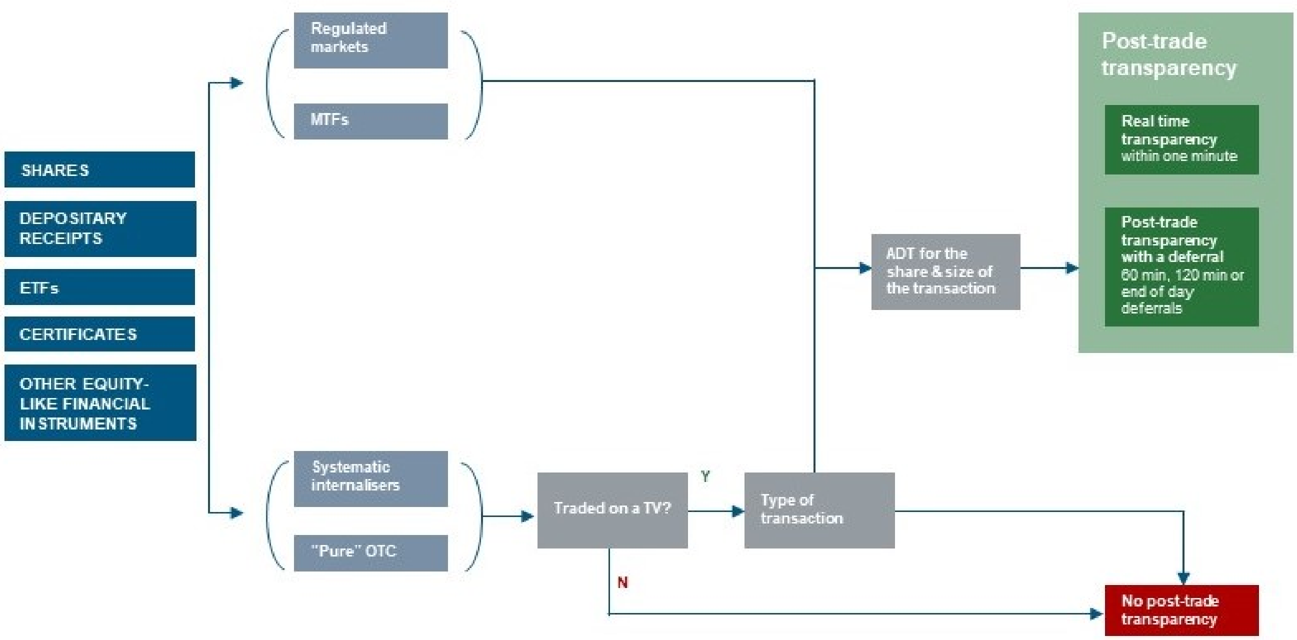

Diagram illustrating the post-trade transparency regime applicable to equity and equity-like financial instruments (extract from p. 83 of ESMA's CP on equities transparency).

Non-equities SI CP

MiFID II introduced a pre-trade transparency regime for non-equities SI that differs significantly from the regime for equities. The rules require SIs to make public firm quotes in instruments for which there is a liquid market when they: (i) are prompted for a quote by a client, (ii) agree to provide a quote, and (iii) deal in sizes below the size specific to the instrument (SSTI). For illiquid instruments, SIs are only required to disclose quotes to their clients on request if they agree to provide a quote (although there is a somewhat cyclical exemption available for illiquid instruments).

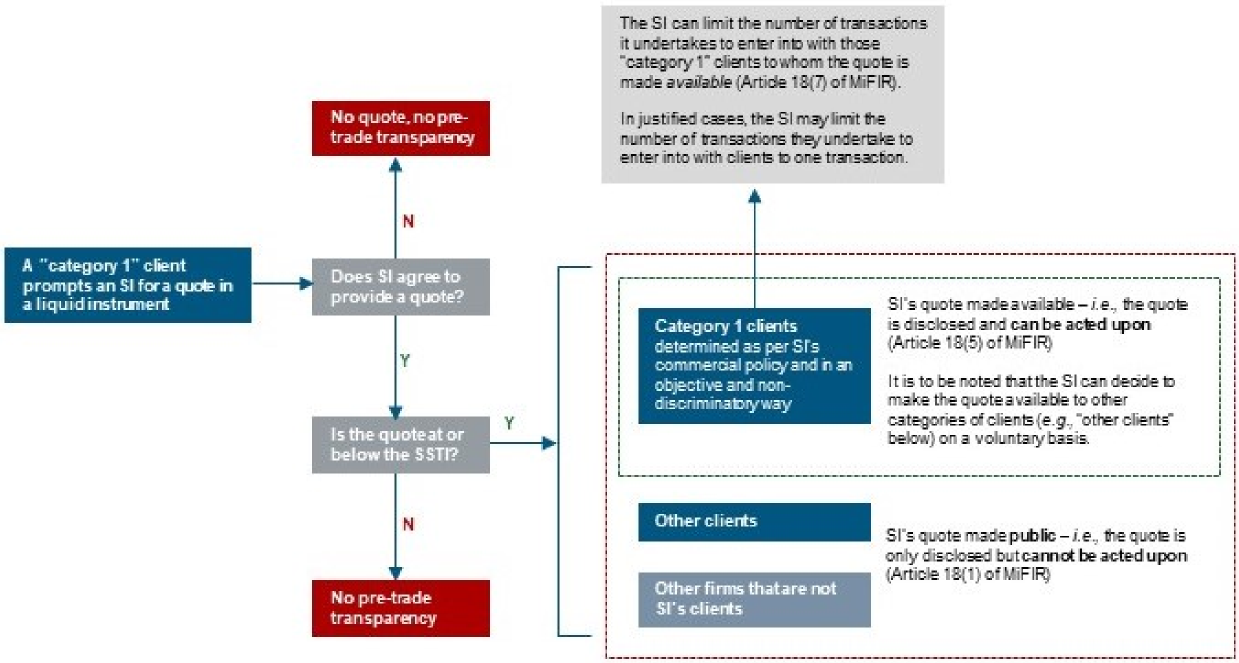

Diagram illustrating an SI's obligations in relation to liquid non-equity instruments (extract from p. 8 of ESMA's CP on non-equities SIs).

ESMA's Observations

ESMA notes that the pre-trade transparency regime for liquid non-equities leaves room for discretion, resulting in divergence. In particular, it notes that firms have adopted differing interpretations of what constitutes a firm quote, with some firms only providing transparency once the final price has been negotiated and agreed with a requesting client. Given that this price may not be known until the client agrees to the trade, the result is that pre-trade transparency is given at almost the same time as post-trade transparency. However, ESMA states that firm quotes should reflect the liquidity that is available more broadly. As such, ESMA is inviting feedback on whether it should clarify what constitutes a firm quote and, if so, its characteristics.

Similarly, ESMA has observed that there are a range of factors set out in SIs' commercial policies that are being used to deny access to quotes (*e.g.*, whether the potential counterparty is also an SI, credit risk, or profitability). ESMA has not opined on the merits of the various factors noted, but is looking to determine the impact on SI clients — *i.e.*, whether clients have "easy access" to SI prices.

ESMA notes concerns that some SIs are operating as *de facto*, unauthorised trading venues and that the less stringent rules applicable to them mean that activity is shifting off venues and onto SIs. As such, ESMA queries whether the non-equities SI and trading venue regimes should be aligned (although ESMA acknowledges that the requirements for SIs are more onerous than those for trading venues, since SIs are on risk and must disclose their identities alongside their quotes).

Finally, acknowledging the "meaninglessness" of the illiquid non-equities SI regime — *i.e.*, that unless a competent authority decides not to grant it, the operation of the illiquid waiver for SIs means that, in practice, transparency is never given for illiquid non-equities. As such, ESMA queries whether the regime should be abolished altogether.

ESMA's Preliminary Recommendations

ESMA suggests that SIs should only be required to trade on the published quote with the requesting client and should have discretion to trade with other clients on a case-by-case basis, indicating that the priority should be access to price-forming information as opposed to prices themselves.

ESMA observes that, currently, SI's commercial policies take divergent approaches to what constitutes "exceptional market circumstances" (when SIs may justifiably stop quoting), and proposes defining and aligning the concept with that currently used for market-making agreements under Article 3 of Commission Delegated Regulation (EU) 2017/578. This would mean that SIs would be able to withdraw liquidity when they face (amongst other things): (i) technological issues, (ii) risk management issues in relation to regulatory capital margining and access to clearing, and (iii) the inability to hedge a position due to a short-selling ban.

Finally, to ensure that the data being made transparent is comparable, ESMA thinks that it should develop RTS setting out the data to be published and the requirements to be met by SIs when doing so.

Conclusion

Although both CPs profess to suggest ways in which the relevant regimes could be simplified, the focus and outcome differs. It is clear that ESMA is looking to increase the level of equities transparency being provided and to limit further the amount of dark trading that occurs. The proposals in the non-equities SI CP, however, are alive to the balance that needs to be struck between providing meaningful transparency and acknowledging the risks faced by SIs when trading from proprietary capital. Nonetheless, if the proposals are implemented "as is", firms will have to make a number of adjustments to their existing builds to accommodate what would essentially be "MiFID 2.5".

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