APT Reaction to the ESMA Consultation Paper on MiFID II/ MiFIR review report on the transparency regime for equity and equity-like instruments, the DVC and the trading obligations for shares

17 March 2020

Introduction

Please make your introductory comments below, if any

The Association of Proprietary Traders represents 23 independent proprietary trading firms based in the Netherlands. Since the opening of the first European Options Exchange in 1978, Amsterdam has become a global centre for proprietary trading, with a concentration of bigger and small sized independent trading firms. Most of our members operate as market makers on exchanges in and outside the EU and buy and sell financial instruments on own account. On the basis of an obligation following from MiFID II market makers commit to continuously providing liquidity to the market under all circumstances. Proprietary firms perform a "warehousing" function, where supply and demand for financial instruments do not always meet. Our members enable retail investors as well as institutional investors to invest in, or divest, financial instruments including shares, bonds, options and ETFs. Over the past 30+ years and to the benefit of institutional and retail investors alike, activities of proprietary trading firms have contributed to transparent and liquid capital markets and to tightening spreads between bid and offer price. We are happy to answer any questions which may rise from this response and provide more information.

List of APT members

- Algorithmic Trading Group	- Market Wizards
- All Options	- Nino Options
- Criterion Arbitrage & Trading	- Nyenburgh
- Cross Options	- Optiver
- Da Vinci Derivatives	- ORA Traders
- DRW	- Peregrine Traders
- Flow Traders	- Tower Research
- Gelber Group	- Quantlab
- IMC	- Utr8 Group
- Jane Street	- WEBB Traders
- Jump Trading	- 323 Trading
- Mako	

Striking the right balance between LIT and dark trading

We support the objectives of the MIFID framework to promote market transparency, to enhance a robust price formation process and prevent disorderly markets. This means striking the right balance between protecting LIT market price discovery and recognizing the contribution of dark orders to orderly markets, for example for large trade sizes. In principle, we believe that platforms and flow should be accessible and subject to an interaction between supply and demand on LIT markets, which are the most important platforms for price discovery. Below large sizes, all transactions should be price-forming and transparent and all liquid instruments should be traded on LIT markets (e.g. regulated markets, MTFs). However, any diversion back to incumbent trading venues should not lead to exchanges increasing trading/access/data or other fees.

The right balance between LIT and dark seems to be missing in parts of the equity markets at the moment. For example, on the basis of public RTS 28 reports we assess that a substantial size of Dutch retail flow ends up at aggregators and third country investment banks. While some of the flow may be routed back to LIT venues, we have strong indications that a sizeable portion of the flow is executed without being subject to the price formation process, i.e. is held captive and internalized. We cannot assess if, and to what extent, flow is effectively matched for practical purposes given the large value and amount of orders being so internalized. While these prices may seem adequate from a Best Ex perspective, we cannot rule out that pricing would have been better if the order would have interacted with the supply and demand dynamics on LIT venues. While PFOF is prohibited, it should be established if aggregators, including non-EU investment banks, are still able to offer other soft inducements that provide benefits to the party routing flow to their platforms, f.e. because the full trade life cycle of execution, clearing and custody is bundled into one cost package. Increasing internalisation of retail flow could lead to a decreasing appetite amongst market makers to be at risk and a widening of spreads. This will come at the expense to price discovery and the Capital Markets Union's objective to make Europe less dependent on banks. The end investor will end up – albeit unconsciously – paying the bill.

On the other hand it is important to highlight that MiFID I introduced much needed competition and highly necessary pricing pressure on (oligopolistic) incumbent trading venues. To get more insight into this, it would be good for ESMA to further analyse what is holding back parties to trade on exchange: better metrics on other platforms, a more fitting offering, costs, "hassle" or competition? How can exchanges be persuaded to provide the services the market is looking for, as well as making reasonable changes to cut back inefficiencies and lower costs and fees? Is there an appetite for simpler and less expensive exchange offerings, appropriating some of the flow that leaked to other platforms?

Q1. What is your view on only allowing orders that are large in scale and orders in an order management facility to be waived from pre-trade transparency while removing the reference price and negotiated trade waivers? Instead of removing the RP and NT waivers, would you prefer to set a minimum threshold above which transactions under the RP and NT waivers would be allowed? If so, what should be the value of such threshold? What alternatives do you propose to simplify the MiFIR waivers regime while improving transparency available to market participants? Please explain.

The current set of waivers is too extensive and has not steered the market in the right direction. Combinations of waivers for smaller size trades are used to circumvent transparency and print negotiated trades on trading venues, while there has been no accessible price formation process. ESMA should ensure that smaller size trades (retail) are being traded on the LIT markets.

However, a waiver for trading above-LIS (wholesale) trades is legitimate. The LIS thresholds may be set differently for classes of liquidity, thereby addressing the instrument's characteristics.If the LIS waiver is set up well (lowered and liquidity taken into account), the RP and NT waivers would have a reduced scope. There is potential for keeping the RPW for less liquid instruments; trading at the transparent primary market midpoint by interested parties could remain available for (highly) illiquid instruments. We do not see an incentive for keeping the NTW: negotiated trades should be seen as wholesale trades (> SMS / LIS).

Last, before removing any waivers APT would encourage ESMA to analyse the consequences of removal. APT is concerned that the volume that previously would have traded via the NT/RP waiver ends up being traded somewhere else than the LIT markets (eg SIs).

Q2. Do you agree to increase the pre-trade LIS threshold for ETFs to EUR 5,000,000? Please explain.

We believe that the ETF market should be viewed and analysed in a slightly more granular manner than as a single bucket classification. Because of their relevance for institutional investors, a significant portion of ETFs trades in large sizes. They are also often traded on RfQ-platforms (incl. MTFs) and sometimes bilaterally, or otherwise outside CLOB. This skews average trade value and results in a high proportion of LIS waiver usage, while this is not necessarily bad or broken: wholesale size trades require use of the LIS waiver and delayed reporting to protect the buyside as well as the liquidity provider in the institutional market (e.g. the buyside's interest is not immediately broadcasted, and the liquidity provider has sufficient time to hedge its position while not being picked off as a result of premature transparency).

For below-wholesale size, depending on the individual characteristics of an individual ETF, we fully agree there should be transparency that is equal to that for equity instruments if their characteristics are similar. We note, however, that the characteristics of ETFs themselves differ from ordinary equities. They are in some ways derivative instruments whose liquidity is informed by the instruments themselves, but also by the liquidity of the underlying instruments. The trading behaviour and liquidity profiles of individual ETFs vary substantially across individual products. This makes establishing the correct LIS threshold a more refined exercise.

Because of the above, we do not feel comfortable that a single, elevated LIS threshold for all ETFs is the correct solution. ESMA should adopt transparency thresholds that more accurately reflect the liquidity of individual ETFs and their constituent instruments. If ETFs are regarded to be in the equities domain, they could be subject to a similar regime as for equities (provided this is sufficiently simple and granular). Further follow-up with the market is needed on this point.

Q3. Do you agree with extending the scope of application of the DVC to systems that formalise NT for illiquid instruments?

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Q4. Would you agree to remove the possibility for trading venues to apply for combination of waivers? Please justify your answer and provide any other feedback on the waiver regime you might have.

As noted in Q1, we notice that sometimes waivers or combinations are being used for smaller size trades being traded in the dark. This is something that should be prevented. However, APT does recognise the utility in trading venues that use combinations of waivers.

Q5. Do you agree with the proposal to report the volumes under the different waivers separately to FITRS? Please explain.

This would indeed add to transparency. However, if only the LIS waiver would remain, this would be implicitly the case anyhow.

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.

We suggest ESMA to consider a package of the following measures:

1. Enhance investor protection by
   - ensuring that flow up to large size is addressable on accessible, competitive and transparent platforms, after analysis of a sensible threshold for wholesale sizes for relevant instruments, which we assume lies somewhere between SMS and LIS;
   - banning Payment For Order Flow in the whole EU and enforcing such a ban – and instigate a ban as well for soft inducements or cross-selling benefits; and
   - ensuring that investor flow is adequately competed for by scrutinizing arrangements that can open the door for undue internalization or conflicts of interest, f.e. when a large institution offers additional services such as transaction reporting or cross-subsidizes other business lines in exchange for flow from particular (retail) investors (a form of bundling akin to research and execution bundling)
2. But also ensure that costs of trading on exchange are not prohibitive to incentives to revert to LIT.

Q7. Which option do you prefer for the liquidity assessment of shares among Option 1 and 2? Do you have an alternative proposal? Do you think that the frequency of trading should be kept as a criterion to assess liquidity? If so, what is in your view the appropriate thresholds for the percentage of days traded measured as the ratio between number of days traded and number of days available for trading (e.g. 95%, 90%, 85% etc.)? Please explain.

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Q8. Do you agree in changing the approach for ETFs, DRs as proposed by ESMA? Do you have an alternative proposal? Please explain.

We believe that the ETF and DR market should not be viewed and analysed as a single bucket classification. Please refer to Q2 for a more detailed discussion. To the extent individual ETFs, DRs and certificates share liquidity profiles with other equities they can be treated with the same transparency requirements. Wholesale exclusion, or implementing single thresholds governing a whole asset class, is perhaps somewhat crude. Applying a more granular regime that is similar or the same to that for equities avoids designing separate regimes and avoids a 'one size fits all' regime that would poorly fit individual instruments within a given asset class. ESMA should adopt transparency thresholds that more accurately reflect the liquidity of the ETFs, DRs and certificates (and their constituent instruments) and further follow-up with the market is needed on this point.

Q9. Do you agree in removing the category of certificates from the equity-like transparency scope? Please explain.

We believe all categories of equities and equity like instruments including certificates should be in the equity like transparency scope in order to promote more LIT trading and avoid creating exemptions that can affect transparency. Hence, we do not agree to remove the category of certificates from the equity-like transparency scope.

Q10. Do you agree in deeming other equity financial instruments to be illiquid by default? Please explain.

As discussed in Q2, we think that the treatment of equities and equity-like instruments should be based on their actual characteristics. Deeming a whole class of instruments as illiquid per se deviates from that principle. We would suggest ESMA to assess instruments on their merits.

Q11. Do you agree in separating the definition of conventional periodic auctions and frequent batch auctions? Do you agree with ESMA's proposal to require the disclosure of all orders submitted to FBAs? Please explain.

We note that the development of frequent batch auctions arose after the MiFID 2 texts were finalised, and as such, they do not perfectly fit within the definition of conventional periodic auctions included within the current MiFID 2 text. We are therefore supportive of a new standalone definition of FBAs. We are supportive of the requirement for orders submitted to FBAs to be pre-trade transparent to the market unless they fall into one of the available waivers under MiFID 2.

We share ESMA's observation that some FBAs are used to cross a position between two market participants, while labelled as an 'exchange' trade, while they are not contributing to price formation. That is not in line with MiFID's objectives to promote transparency and assure Best Ex for the end investor. Such trades should be done under full transparency on a regulated market or MTF, or (for larger sizes) on RfQ MTF. ESMA could consider to open up FBA's for competitive pricing, to ensure open access, price transparency and sufficient time to quote.

We are concerned with the potential for many FBA systems to arise particularly in case the waivers and/or SI trading would be curtailed, and would ask regulators to limit the fragmentation and proliferation in FBAs as this would be seen as a replacement for waiver/SI trading instead of a multilateral competitive venue, especially if those platforms are run by brokers instead of exchanges.

Q12. Do you agree that all non-price forming systems should operate under a pre-trade transparency waiver? Please explain.

As noted in our response to question 11 we would agree that non-price forming systems should operate under a pre-trade transparency waiver. However we note it is not always clear what a price forming versus non price forming system is. The market welcomes further discussion on this topic.

Q13. What is your view on increasing the minimum quoting size for SIs? Which option do you prefer?

The APT supports increasing the minimum quote size to 100% of SMS.

Q14. What is your view on extending the transparency obligations under the SI regime to illiquid instruments?

The APT believes that it would not make sense to extend the transparency requirements by definition to all illiquid instruments. We do however believe it would make sense to ensure that more (currently) illiquid instruments qualify as liquid (and thus become subject to the transparency obligations).

Q15. With regard to the SMS determination, which option do you prefer? Would you have a different proposal? Please explain.

The APT believes that it would not make sense to extend the transparency requirements by definition to all illiquid instruments. We do however believe it would make sense to ensure that more (currently) illiquid instruments qualify as liquid (and thus become subject to the transparency obligations). If that happens then there will be only need for a table for liquid instruments.

Q16. Which option do you prefer among Options A, B and C? Would you suggest a different alternative? Please explain.

Different alternative: eliminate DVCs.

Q17. Would you envisage a different system than the DVC to limit dark trading? Please explain.

Yes, an alternative would be to have all equities trading below wholesale size (LIS or a new metric based on objective instrument characteristics)) to LIT markets.

Q18. Do you agree in removing the need for NCAs to issue the suspension notice and require trading venues to suspend dark trading, if required, on the basis of ESMA's publication? Please explain.

We have no strong opinion

Q19. Do you agree in removing the requirement under Article 5(7)(b)? Please explain.

We have no strong opinion

Q20. Please provide your answer to the following survey (<= click here to open the survey) on the impact of DVC on the cost of trading for eligible counterparties and professional clients.

Not relevant for APT

Q21. Do you agree in applying the DVC also to instruments for which there are not 12 months of available data yet? Please explain.

We have no strong opinion

Q22. Do you agree foresee any issue if the publication occurs after 7 working days instead of 5? Please explain.

We have no strong opinion

Q23. Do you agree that the mid-month reports should not be published? Please explain.

We have no strong opinion

Q24. Do you agree with ESMA's proposal to include in Article 70 of MiFID II the infringements of the DVC suspensions? Please explain.

We have no strong opinion

Q25. Do you agree with ESMA's assessment that the conditions for deferred publication for shares and depositary receipts should not be subject to amendments? If not, please explain.

Agree

Q26. Do you agree with ESMA's proposal to increase the applicable threshold for ETFs and request for real-time publication for transactions that are below 20,000,000 EUR? If not, please explain.

Please refer to Q2, setting out our observations regarding ETFs.

Q27. Do you agree with ESMA assessment of the level of post trade transparency for OTC transactions?

Agree

Q28. Do you agree with the proposal to report and flag transactions which are not subject to the share trading obligations but subject to post-trade transparency to FITRS? Please explain.

We believe that this will not render meaningful results. We would like to avoid attracting additional flagging/reporting obligations and focus on reporting instruments with an EU primary listing only. The primary tool to improve transparency would be the post-trade tape.

Q29. What is your experience related to the publication of post-trade transparency information within 1 minute from the execution of the transaction? Do you think that the definition of "real-time" as maximum 1 minute from the time of the execution of the transaction is appropriate/too stringent/ too lenient? Please explain.

Where possible, real-time printing should be completed as close to real-time as reasonably possible and not be artificially delayed. However, there may be hedging, manual processes or verification where reporting can take up to 1 minute. Such lag may not be abused but this is subject to MAR.

Q30. Do you agree with ESMA's approach to third-country trading venues for the purpose of transparency requirements under MiFID II? If no, please explain.

To require printing in the EU for parties trading on non-EU venues, or parties trading with non-EU counterparties would make trading more costly. Imposing such an obligation might trigger reciprocal transparency requirements for an ever-increasing number of third-country jurisdictions. Both are not desirable from a business perspective. Non-EU counterparties will probably require their EU market makers or brokers to print on their behalf, for transactions that have a price impact on a non-EU market place.
A more pragmatic approach would be that where an EU market is the primary market place for an instrument, already available information/transparency is considered sufficient.

Q31. Do you agree that the scope of the share trading obligation in Article 23 of MiFIR should be reduced to exclude third-country shares? If yes, what is the best way to identify such shares, keeping in mind that ESMA does not have data on the relative liquidity of shares in the EU versus in third countries? More generally, would you include any additional criteria to define the scope of the share trading obligation and, if yes, which ones?

We agree with ESMA's observation to be pragmatic here. Any other outcome could be misapplied in (geo)political considerations and lead to more undesirable friction on global capital markets.
Identifying the most liquid markets/primary market place with the highest average traded value, even outside of the EU, should be technically feasible, whether or not on the basis of commercially available information (multi-sourced, or subject to competitive tender).

Q32. Would you support removing SIs as eligible execution places for the purposes of the share trading obligation? If yes, do you think SIs should only be removed as eligible execution places with respect to liquid shares? Please provide arguments (including numerical evidence) supporting your views.

We do not believe that removing SIs as an eligible platform for purposes of the STO should be a goal in itself. Such measure should be considered a possible *means* to the end of a healthy price formation process and creating the offer of deep pools of liquidity to as many investors as possible (cf. purposes of MIFIR). SIs have shown to respond to a demand for investors to have lower cost, less-hassle trading.

For us the key concern lies in that some SI's do not contribute to price discovery, are "closed shops" and therefore that flow is non-interactable/addressable. We are also concerned that internalisation activity combined with other services or business lines can introduce serious conflicts of interest, obscure the true costs of trading and post-trade services for investors, and that such 'bundled' arrangements reduce the competition available on an order-by-order and overall basis to investor's orders when traded in these models. Sis significantly contribute to the ability for firms to operate in this way. Between these embedded advantages that SIs can offer investors and the fact that these liquidity pools are 'closed' to competition by other market participants, there is a risk that existing SI operators become difficult to unseat.

As a matter of principle, we would like to see flow interacting with the best possible price formation process (regardless of which platform is being used), and that such platforms are subject to the same rules/level playing field. We are aware that institutional investors performing large block transactions can have legitimate value from bilateral trading via an SI, but ideally most flow should be subjected to competitive price formation on open platforms.

More harmonization of the requirements for SI's, RM & MTFs to ensure accessibility and addressability of flow, could also be another means to ensure a contribution to price discovery and a deep pools of liquidity.

Q33. Would you support deleting the first exemption provided for under Article 23 of MiFIR (i.e. for shares that are traded on a "non-systematic, ad-hoc, irregular and infrequent" basis)? If not, would you support the introduction in MiFIR of a mandate requiring ESMA to specify the scope of the exemption? Please provide arguments supporting your views.

We would support having the same rules for everyone and remove the exemption.

Q34. Would you support simplifying the second exemption of Article 23 of MiFIR and not limiting it to transactions "carried out between eligible and/or professional counterparties"? Please provide arguments supporting your views.

Yes, the share trading obligation should be applied universally (whether or not through using a broker), as long as the STO applies to instruments with their primary listing in the EU only

Q35. What is your view on the increase of volumes executed through closing auctions? Do you think ESMA should take actions to influence this market trend and if yes which one?

APT shares the observation of increasing volumes in the closing auctions. This might result in the liquidity picture outside auctions sliding, price formation in SME and Mid Cap stocks worsening, a declining tradability in cash equity instruments and less competitive markets.

In order to take the right measures, we would recommend ESMA to look further into the reasons behind this development. The trend of passive investing (ETFs) might be one of them. Asset managers often use ETFs and have to mark their positions at a closing value or NAV. That's why auctions could be used to guarantee a clearly defined 'actual' benchmark price for asset managers or fund administrators. Another reason is probably that exchange fees, and closing values, are still largely the realm of incumbent, primary listing, markets. Therefore it has become attractive for market participants, such as brokers to find effective and inexpensive solutions, such as collating/netting an end-of-day position on behalf of their clients, against one or more market participants internalizing such flow end-of-day at lower cost than on a trading on-venue. Particularly when their clients are not so timing or price sensitive.

This development could be countered by a package of (1) reducing costs of trading on exchange and (2) ensuring addressability for market parties contributing to price formation, with sufficient time for quoting. A weighted closing price might also be a solution, but would be complex to implement.