MiFID II / MiFIR review report on the transparency regime for equity and equity-like instruments, the double volume cap mechanism and the trading obligations for shares. International Bulletin of June 2020.

ESMA has published a consultation document on the transparency regime for equity and equity-like instruments in compliance with the mandate under Article 52(1) to (3) of MiFIR, which requires ESMA to submit a report to the European Parliament and to the Council on the impact in practice of the transparency obligations established pursuant to Articles 3 to 13 of MiFIR, and the double volume cap (Article 5 of MiFIR). Additionally, ESMA has decided at its own initiative to also include an assessment of the share trading obligation (Article 23 of MiFIR) and the transparency provisions applicable to SIs (Articles 14-21 of MiFIR). For practical reasons, ESMA has also considered it appropriate to publish another report analysing the transparency regime applicable to non-equity instruments at a later date.

The consultation document contains an analysis and proposals for specific modifications to MiFIR, detailed below, aimed at simplifying the structure of the transparency regime applicable to equity and equity-like instruments.

The pre- and post-trade transparency requirements for shares admitted to trading on regulated markets were already applicable under MiFID I. MiFIR aims to align the transparency rules of regulated markets (RM) with multilateral trading systems (MTS), in addition to standardising the transparency requirements applicable to shares traded in both trading venues. Furthermore, given that trading in depository receipts, ETFs, certificates and other similar financial instruments (equity-like instruments) is done in a similar way to shares, MiFIR also extends the transparency provisions to those financial instruments.

Pre-trade transparency requirements for trading venues in respect of shares, depository receipts, ETFs, certificates and other similar financial instruments

Assessment of the current level of pre-trade transparency

MiFID II / MiFIR built on the pre-trade transparency requirements already present in MiFID I in order to create a stronger transparency regime. Article 3 of MiFIR requires market operators and investment firms operating a trading venue to make public current bid and offer prices and the depth of trading interests at those prices that are advertised through their systems for equity and equity-like instruments. The new pre-trade transparency requirements, in conjunction with the post-trade transparency requirements, aim at increasing the transparency for equity and equity-like instruments, thereby contributing to an improved dissemination of information, a more efficient price formation process and ultimately supporting the accurate valuation of products. However, MiFIR also provides for waivers from these obligations, which should not undermine the transparency framework or the efficiency of the price formation process.

Based on this scenario, ESMA’s has presented an initial assessment of how the pre-trade transparency framework delivered on the objectives of MiFID II / MiFIR and includes some recommendations on how shortcomings identified could be addressed in the future. The assessment focuses in particular on the Level 1 text. However, since the Level 2 provisions are key for applying the pre-trade transparency regime, the assessment covers at times also the Level 2 framework. The level of pre-trade transparency can be assessed firstly by comparing the pre-trade transparency information available before and after the application of MiFID II / MiFIR. Secondly, by assessing the volume and number of trades not executed on-venue. Thirdly, by observing the impact of exemptions on total volume and operations.

ESMA concludes that the overall objective of MiFID II / MiFIR has not been fully achieved and highlights a clear prominence of LIS (large-in-scale) and OMF (order management facility) exemptions and the use of a complex combinations of waivers. Therefore, ESMA is looking at ways of how to simplify the regime with a view to improving pre-trade transparency. ESMA considers it relevant to consider the removal of the reference price (RP) and negotiated trade (NT) waivers for liquid (Article 4(1)(a)(i) of MiFIR) and illiquid instruments (Article 4(1)(b)(ii) of MiFIR) respectively. This would increase the amount of pre-trade transparency available in the market, but the net gain in transparency might eventually be marginal if orders were to migrate to be executed under the LIS waivers. Another result could be a migration to SI-trading resulting in increased liquidity fragmentation.

This change would require amendments to Article 4 MiFIR and the relevant RTS 1 provisions . Furthermore, this proposal would also make the double volume cap (DVC) mechanism redundant, hence resulting in the deletion of Article 5 of MiFIR.

An alternative to the complete removal of the NT and RP waivers would be to allow the trading under such waivers only for orders above certain sizes. ESMA considers that the minimum order size should be below the current LIS and is seeking stakeholders views on what an adequate level for such minimum order size could be.

Definition of liquid market

Article 2(1)(17) of MiFIR provides for the definition of a liquid market, which is further specified in Commission Delegated Regulation (EU) 2017/567. Such definition is relevant to determine the instruments for which SIs are subject to pre-trade transparency (up to the SMS), for the application of the different NT waivers for on-venue trading, which in turn also affects the application of the double volume cap (DVC) regime that limits the use of the NT waiver for liquid instruments.

Considering that the purpose of MiFID II / MiFIR is to increase transparency and the strong growth in SIs, ESMA considers it appropriate to limit the parameters for the liquidity assessment for equity and equity-like instruments only to those that appear to be relevant also with the purpose to increase the number of instruments that can adequately be considered as liquid.

In particular, for shares, ESMA proposes to limit the choice to the following options:

• Option 1: which would use as parameters to assess liquidity (i) the average daily number of transactions and (ii) the average daily turnover. This proposal would require the modification of Level 1 and in particular, the deletion of the (i) daily traded condition (ii) use of the free-float within Article 2(1)(17)(b) of MiFIR.

• Option 2: which would use as parameters to assess liquidity (i) the average daily number of transactions, (ii) the average daily turnover and (iii) the market capitalisation. This proposal would also require the modification of Level 1 and in particular, (i) the deletion of the daily traded condition (ii) the modification of the use of the free-float with that of the market capitalisation within Article 2(1)(17)(b) of MiFIR.

Emergence of New Trading Systems: Frequent Batch Auctions (FBAs)

Frequent Batch Auction (FBA) systems for equity instruments are a new type of periodic auction trading system, which started gaining market share with the application of MiFID II in 2018, in particular following the first suspension of trading under the DVC. This increase, due among other aspects to the use of FBA systems to circumvent the application of the DVC, means that these systems require special consideration.

Therefore, ESMA considers it advisable to further specify the post-trade transparency definitions and obligations included in RTS 1 on conventional auctions and FBAs. Furthermore, it suggests that all orders (volume and price) sent to FBAs should be published to meet MiFIR's pre-trade transparency requirements, which would require a change of Level 2 legislation.

The systematic internaliser regime

The concept of SI was already introduced under MiFID I and has increased in scope under MiFID II. The overall objective of the regime is twofold. Firstly, it is to make transactions which take place outside of a trading venue more transparent. Secondly, it is meant to level the playing field between the rules applicable to trading venues and to investment firms which trade on own account. MiFIR also introduces the standard market size (SMS) criteria applicable to SIs so that they meet pre-trade transparency requirements.

However, the regime established for SIs does not appear increase transparency. The first main reason for the lack of transparency available under the SI regime relates to the absence of any pre-trade transparency requirements for illiquid instruments. Secondly, the limited number of transactions below the SMS threshold. It should be noted that the calculation methodology of the SMS thresholds is significantly different than that applicable to the LIS thresholds for trading venues. The conjunction of the reasons stated shows that there is not only a significant amount of trading currently taking place that is not being subject to pre-trade transparency requirements.

ESMA proposes some changes to Level 1 legislation, specifically to amend the minimum quote size from 10% (Article 14(3) of MiFIR) to 50% (option 1) or 100% (option 2) of the SMS. It is also considering whether to extend the transparency obligations to illiquid instruments or changing the calculation methodology of the SMS thresholds.

Double Volume Cap (DVC)

The purpose of the DVC is to ensure that the use of certain waivers does not unduly harm price formation by limiting the trading under the RP waiver or the NT waiver for liquid instruments as follows: the trading volume under the waivers against the total volume traded on EU trading venues over the last 12 months for a specific instrument should not be higher than 4% at the level of a single trading venue, or higher than 8% for all the venues combined. In such cases NCAs have to suspend the use of the authorised waivers for the relevant instruments for a period of 6 months.

There are currently no jurisdictions outside the EU with similar measures to the DVC. Brexit raises concerns about the future application of the DVC based on the assumptions that there will still be a large number of instruments that will be traded in the EU 27 and if and how the DVC will be applied in the UK. In addition, ESMA will conduct an analysis of the impact of the DVC on cost of trading and market structure, taking into account the responses of the participants to a series of questions in the consultation. Although the consultation factors in the disappearance of the DVC (by limiting the available waivers under the transparency regime to LIS and OMF), the analysis shows that the DVC has had positive effects market liquidity. In particular, instruments experience a decrease in the bid-ask spread and an increase in the average trade size. To balance these advantages with the complexity of the system, ESMA proposes the following alternatives for adjusting the mechanism (options B and C require an amendment to Article 5 of MiFIR):

- Option A: to keep the 4% TV level threshold and the 8% EU level threshold.
- Option B: to eliminate the 4% TV level thresholds and keep the EU level threshold at 8%.

- Option C: to eliminate the 4% TV level threshold and reduce the EU level threshold to 7%.

Other considerations raised in the consultation related to the DVC include application of the DVC to instruments without 12 months of data, the publication of monthly and mid-monthly reports within seven business days (instead of the current five), the possible elimination of the mid-monthly reports provided for in Article 5 (5) of MiFIR and, lastly, the inclusion in Article 70 of MiFID II sanctions for infringements of the DVC.

Post-trade transparency regime in respect of shares, depositary receipts, ETFs, certificates and other similar financial instruments

Assessment of the post-trade transparency framework for trading venues

The objective of MiFIR is to increase post-trade transparency but at the same time, to offer through deferrals appropriate protection to market participants and in particular those executing large trades. ESMA has assessed transparency by comparing volumes of transactions subject to real-time publication against those benefiting from a deferral.

ESMA concludes that the MiFIR deferred publication regime meets its objective of maintaining a high level of transparency. However, the assessment demonstrates that the volume of deferred transactions in ETFs is significantly higher than for other equity instruments. Therefore, ESMA would therefore see merit in revisiting the thresholds set out for ETFs to ensure that the proportion of deferred transactions is more closely aligned with the other types of equity instruments (specifically, shares and certificates of deposit). More specifically, ESMA would propose to increase the minimum qualifying size of transaction for permitted delay with a 60 minutes delay from €10,000,000 to €20,000,000. This proposal would require a change in Level 2 legislation.

Assessment of the post-trade transparency framework for OTC transactions

Article 20 of MiFIR requires investment firms to make information on transactions in financial instruments traded on a trading venue public through APAs (authorised publication agents).

ESMA has analysed the impact of the use of deferrals for OTC and SI transactions to understand how the deferral regime is being applied in practice for such trades and considers that the applicable deferrals thresholds should be maintained aligned to those applied on-venue. ESMA also proposes that the transactions not subject to the trading obligation for shares but subject to post-trade transparency requirements should be reported to and processed through the Financial Instruments Transparency System (FITRS). Lastly, it seeks opinions on the definition of “real-time” as maximum 1 minute from the time of the execution of the transaction.

Transparency requirements applicable to third country transactions

The post-trade transparency requirements applicable in Articles 20 and 21 of MiFIR do not clarify whether the requirement publish transactions through approved publication arrangements (APA) applies also to transactions concluded on a third-country trading venue that are not covered by a Commission’s equivalence decision. ESMA opinion of December 2017 stated that investment firms should not be required to re-publish information in the EU about transactions concluded on a third-country trading venue subject to provisions similar to those of the MiFID II framework. The authority also committed to publish a list of third-country trading venues that meet these requirements. Therefore, ESMA does not see any need to change Level 1 provisions and considers the supervisory convergence tool used to be sufficient.

Trading obligation for shares

ESMA considers it essential to review the regime established in Article 23 of MiFIR on the trading obligation for shares admitted to trading in the EU, although this is not expressly mentioned in Article 52 of MiFIR.

Scope of the trading obligation for shares

The application of the share trading obligation to third country shares has been challenging in practice for three main reasons: (i) the lack of liquidity of those shares on EU trading venues, (ii) the equivalence regime, and (iii) overlap with equivalent trading obligations applicable in other third countries. The document concludes that there are reasons justifying an exclusion of third country shares from the scope of the MiFIR trading obligation, although how this should be done presents difficulties. ESMA recognises that the ISIN approach, which at first glance would be the best option, may not be suitable in all cases. One alternative to complement the EU ISIN approach could be to consider whether the issuer has actively sought to have its shares admitted to trading on a trading venue in a third country.

Maintaining SIs as eligible execution venues under Article 23 of MiFIR and the exemptions

ESMA asks whether SIs should remain an option and whether the exemptions listed under paragraphs (a) and (b) of Article 23(1) of MiFIR should be maintained. In view of the responses obtained, ESMA highlights the objective of this rule to reduce the liquidity fragmentation and to offer deeper pools of liquidity to investors, although the significant role of SIs in share trading and their increased number could run in contradiction with this goal.

In relation to exemption (a) ESMA believes that if the trading obligation for shares of third countries is eliminated, it would be worth considering whether it should be continued. Likewise, if it is maintained, ESMA proposes that the concept be developed in Level 2 legislation. Lastly, in regard to exemption (b), ESMA proposes to eliminate the mention of eligible and professional counterparties.

Closing auctions

The ESMA document concludes with a study carried out by the AMF on the proportion of shares traded during the closing auctions. This has increased steadily on all the main European regulated markets, where it can exceed 40%. The AMF study explains that the rise in closing auction may stem from four main factors: (i) the expansion of passive management (ETFs); (ii) the entry into force of MiFID II Trade & Cost Analysis reporting obligations; (iii) an aversion to high frequency trading, and (iv) the increasing use of algorithms to execute orders may amplify the phenomenon as they tend to trade when liquidity is historically highest.

Securities and Markets Stakeholder Group – Response to the ESMA consultation document

On 23 March, the SMSG published its opinion regarding the topics covered in this consultation and shows the following positions:

- It accepts ESMA's proposal to maintain the exemption for LIS and OMF, although group members hold different points of view on the RP and NT exemptions.
- The SMSG is in favour of a simplification of the double volume cap mechanism, moving to just one EU-wide cap with a single monthly calculation. The SMSG considers that such simplification would not negatively change the positive effect, if any, of the DVC, but rather limit some of the negative effects of DVC (such as limiting administrative burdens and encouraging the provision of correct data).
- The SMSG agrees to ESMA's conclusions and proposals in the area of post-trade transparency.
- The SMSG believes that the scope of the share trading obligation should be reduced and not include third-country shares since EU regulation should not have extraterritorial reach. The ISIN should be used as the first basis for this assessment. However, as recognised by ESMA, this approach is not suitable in all cases and complimentary criteria are therefore necessary, and a clear priority order should be established.
- Lastly, the SMSG recognises that the volumes have increased at closing auctions. It can be assumed

that the increase is due to market participants’ interest in having access to as much liquidity as possible. The SMSG advises that ESMA should not take action at this time but should continue to study the issue.

Useful link:

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