MARKET FINREG

REGULATORY SPECIALISTS

Submission to

ESMA

In the matter of ESMA70-156-275

13 November 2017

Introduction

On 9 November 2017 ESMA issued a public consultation (ESMA70-156-275) on proposed amendments to MIFID/MIFIR RTS 1.

Kindly consider this submission as a formal response to the same.

I am happy for this response to be publicly disclosed in full.

About the Author

Seb Malik is a leading expert on European financial regulation.

He is the author of the bestselling *MiFID II: A Survival Guide*[1] which has become the de facto reference guide for MiFID II implementation within the EU.

Seb is in the process of authoring a book on SFTR as well as the EU's forthcoming CCP recovery regime.

Market FinReg has provided expert consultancy to Investment Firms; High Frequency Trading firms; ARMs and buy and sell-side software vendors, helping such entities reach MiFID II compliance. **www.marketfinreg.com**

Acronyms

I. Acronyms either mimic the Consultation Paper or are widely understood by industry and shall not be defined.
II. TSR – Tick Size Regime.

Question 1

Do you agree with ESMA's proposal to clarify that SIs' quotes would only reflect prevailing market conditions where price levels could be traded on a trading venue at the time of publication?

Starting Point

1. The departure point is that MiFID II seeks "to make Union financial markets more transparent and efficient and to level the playing field between various venues".2 There should be no regulatory arbitrage between execution venues leading to an artificial flow towards the looser regulated venue.

2. To secure this objective, legislators seek to "ensure that trading in financial instruments is carried out as far as possible on organised venues".3

3. Thus, OTFs were created in order to bring large parts of hitherto uncaptured liquidity into the ambit of MiFID II. Further, the definition of an SI was defined more precisely to prevent liquidity migrating to loosely regulated off-venue liquidity pools.

4. This objective is encapsulated in MiFIR, Recital 10:

> All organised trading should be conducted on regulated venues and be fully transparent, both pre and post trade. Appropriately calibrated transparency requirements therefore need to apply to all types of trading venues, and to all financial instruments traded thereon.

It is within these overarching objectives that ESMA's question 1 must be set.

Rationale

5. RTS 1 Article 1:

> …the risk of an ever-decreasing tick size…and its impact on the orderliness of the market should be controlled by means of a mandatory tick size regime.

6. A TSR determines the minimum difference between two price levels in an order book.4

7. There is a disconnect between the Level I and II texts. 'Regulated Market' has been defined in MiFID II Article 4(1)(21) and is understood, broadly, to refer to exchanges. Trading Venue is similarly defined and is far wider in scope, incorporating additionally MTFs and OTFs. MiFID II Article 49(1) mandates the TSR only on Regulated Markets:

> Member States shall require regulated markets to adopt tick size regimes in…

8. However, Article 18(5) of MiFID II refers MTFs and OTFs to the above Article 49(1) TSR obligation. This is messy and poorly drafted legislation. Far better would have been for Article 49(1) to have directly referred to Trading Venues.

9. Articles 49(3) and (4) call for technical specifications from ESMA. ESMA appears to have noticed the deficiency in the level I text and substitutes Regulated Markets for Trading Venues:

> Trading venues shall apply to orders in shares or depositary receipts a tick size…

10. A question remains: why did legislators fail to extend the TSR to the final entity where equity trading occurs – SIs?

11. I suspect legislators and ESMA felt that equity SI trading volumes were insignificant in comparison to the volumes traded on Trading Venues therefore extending TSR to SIs was unnecessary to prevent the occurrence of disorderly trading conditions. Support for this understanding is found in ESMA's approach in Recital 3 of RTS 11:

> …In view of the characteristics of those financial instruments and the liquidity, scale and nature of the markets on which they are traded, a mandatory tick size regime is not necessary to prevent the occurrence of disorderly trading conditions.

12. ESMA would be correct. However, ESMA failed to account for future trading volumes as SIs could exploit tick size restrictions, as highlighted in ESMA70-156-275 at §10.

13. Industry chatter is rife about HFT firms approaching SIs in order to establish networks of liquidity pools not subject to minimum tick sizes thereby facilitating meaningless fractional price improvement by SI quotes bisecting Trading Venues' order book levels. As ESMA notes, SORs would likely route executions to SIs in preference of Trading Venues leading to disorderly markets as liquidity would be fragmented as well as problems in understanding true market depth as order book levels would not readily aggregate.

14. For these reasons, I agree that the Tick Size Regime should be extended to SIs.

Alternative Solution ESMA Should Consider

15. As for ESMA's proposed remedy this requires analysis. ESMA proposes to indirectly impose a TSR by modifying Article 10 of RTS 1, per the additional bold, underlined:

> The prices published by a systematic internaliser shall reflect prevailing market conditions where they are close in price, at the time of publication, to quotes of equivalent sizes for the same financial instrument on the most relevant market in terms of liquidity…**<u>and where the price levels could be traded on a trading venue at the time of publication</u>**.

16. This lacks precision. The above obligation is triggered by the phrase: "where they are close in price". What is close? There is no legal definition of "close", and it will be subject to interpretation. While "close" would reduce the scope for the "race to the bottom" depicted in ESMA70-156-275 at §10, it would not eliminate it.

17. A better remedy would be to simply extend the TSR (Article 2 of RTS 11) to SIs, per bold underlined:

> Trading venues and SIs shall apply to orders in shares or depositary receipts a tick size which is equal to or greater than…

18. This would achieve a MiFIR objective to "level the playing field between various venues" and prevent an artificial draw away from Trading Venues thereby preventing market fragmentation.

19. This might prove burdensome to some SIs. The net effect would likely be a slight shift of liquidity away from SIs back onto Trading Venues. This would serve to consolidate liquidity and should be welcomed.

Question 2

Do you agree with the drafting amendment described above?

20. I agree with all proposals in ESMA's CP at §16.

References

[1] https://www.amazon.co.uk/dp/0993546536

[2] MiFIR Recital 8; While this recital stated in the immediate context of MTFs and OTFs, the text is read in its generality; emphasis added.

[3] MiFIR Recital 6

[4] RTS 11 Recital 6