PLATO

Transparency regime for equity and equity like instruments

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Plato Partnership ("Plato") is a consortium of buy-side and sell-side firms committed to improving markets, so they can more efficiently serve society.

We believe that for markets to serve society at large, they must prioritise the needs and quality of outcomes for issuers (raising capital) and investors (sources of capital). There are many other stakeholders (all of whom can be considered "intermediaries") who perform vital functions in service of issuers and investors (including exchanges, brokers, market makers), and their contribution should be duly recognised and encouraged – providing that it enhances issuer and investor outcomes. Effective regulation ensures that the interests of these intermediaries is managed in a framework that delivers the right outcomes for investors.

Plato is supportive of the efforts to ensure appropriate transparency in equity and equity like instruments, particularly the focus on improving the quality of post-trade data and consideration of introducing a consolidated tape. However we note with concern the considerations contained in the ESMA consultation on the transparency regime for equity and equity like instruments, and the resulting statements of a number of respondents in their submissions, that execution of all below Large in Scale (LIS) threshold orders should move to lit venues to improve pre-trade transparency.

The stated objective of the recent ESMA consultation was to simplify the current transparency regime. Plato supports the simplification of market structures where this results in better outcomes for issuers and investors. However, we believe that some of the proposals on the consultation, and some of the responses from a number of market infrastructures, if implemented will be detrimental to issuers and investors. Our view is that any changes to the regime should be measured against the overarching goal of creating better outcomes for issuers and investors.

In recent years we have observed significant innovation across the European equities market structure which has resulted in real benefits to end investors. Small retail investors have benefitted from narrower spreads and the lowest transaction fees in history and institutional investors managing retail money have benefitted from a wide range of trading mechanisms and services that have allowed them to minimize slippage, avoid information leakage and reduce their overall market impact. This has maximised investors' returns and reduced issuers' cost of capital, which are important factors supporting economic growth. Both segments of end investors have been provided with significantly improved execution quality that has contributed to overall growth in the European economy.

We strongly believe that moving execution of below LIS orders to lit venues will not create better outcomes for end investors. Continuous lit order books aid price formation and offer a high likelihood of execution, however they inherently favour market participants with the fastest technology. Institutional investors therefore achieve meaningful benefits by complementing their use of lit venues with access to alternative execution mechanisms which prioritise factors other than speed (i.e. size, price, etc.). The assumption that a majority of orders should be pre-trade transparent and price forming does not recognise the significant benefits that execution of below LIS orders on dark and non-continuous venues – Multi-lateral Trading Facilities (MTFs) and Systematic Internalisers (SIs) – provides to end investors. The removal, or further restriction, of Reference Price (RP) and Negotiated Trade (NT) waivers for below LIS orders to be able to execute on dark and non-continuous venues will increase market impact and the cost of execution and limit price improvement opportunities to the detriment of end investors. EU investment firms may also be forced to change their trading behaviour and withhold orders from the market to avoid market impact or information leakage. In addition, investment teams may limit European investment holdings to only the most liquid instruments and this could negatively impact small and mid-cap sectors and their ability to access needed equity financing.

It is also our view that removal of RP and NT waivers may shift volume to alternative execution mechanisms such as opening and closing auctions, removing significant intraday liquidity from the market to the further detriment of end investors.

In detail –

Benefits of executing below LIS orders on dark and non-continuous venues

- Lit continuous order books inherently favour market participants with the fastest technology. Accordingly, investors at times have a preference to search for liquidity in alternative venues such as those that reduce the advantages of speed and can bring investor "natural" interests together.

- In our experience, to manage market impact and optimise execution performance, ~90% of institutional investors' trading behaviour utilises strategies that spread execution across the trading day and access lit continuous order books in parallel to accessing alternative venues. In contrast, only ~10% seeks to exclusively access alternative venues to the exclusion of lit venues(1). This concurrent and symbiotic use, coupled with the robust post-trade transparency regime across all types of venue execution/service, ensures appropriate and sufficient market-wide transparency and the continued robustness of price formation.

- We note the rationale contained in some response submissions to ESMA favouring the removal of RP and NT waivers (and shifting execution of all below LIS orders to lit venues) is the perceived lack of benefits associated with executing smaller trades on dark venues, given their limited market impact. However, in practice large orders are broken up into smaller orders, spread throughout the day and represented concurrently in lit and alternate venues, with the aim of avoiding adverse price moves due to information leakage. If these smaller orders were required to be exclusively executed on lit venues they would be easily identified as part of a larger order by firms with latent sensitive strategies and an important function in protecting from information leakage and resulting market impact would be lost. This would result in increased costs of trading for those smaller orders and the real money behind them.

(1) Based on member estimates

- We are concerned by comments regarding mid-point execution in recent transparency submissions to ESMA stating that midpoint orders are executed at the expense of participants willing to set or display a price and therefore suggest that executing at the mid-point price is not a fair outcome.

  This ignores the importance of mid-point execution to EU investment firms and the price improvement it achieves for end investors across small and large orders. Execution at the mid-point of the reference market best bid and offer is agreed as the global standard that ensures a fair way to split the cost of trading (the bid versus the offer spread) in equal parts between buyer and seller. Execution at mid-point has been an important innovation in global equity markets and represents a key component of cost savings to end investors that provides a real and meaningful impact on investment returns. Mid-point execution is also of benefit in volatile markets as it provides the opportunity to get the best possible price for end investors when buying or selling a security regardless of volatility. The midpoint *is* a fair execution price when two natural counterparties want to execute, with neither wanting nor needing to pay the spread (premium) to access liquidity.

The importance of executing below LIS orders on SIs

- SIs are an important execution mechanism for EU investment firms to access principal liquidity that may not be available on lit and dark venues. SIs use their capital and balance sheet to offer significant market liquidity that facilitates more efficient and better priced investment transactions to EU investment firms and their end investors.

- If SIs were limited to only offer LIS order execution, a significant source of liquidity for below LIS orders would be removed. In this regard we note the sizeable difference between the average trade size on a continuous lit market and LIS thresholds, representing a significant liquidity universe. It would pose material challenges for investors and their intermediaries in managing the implicit cost of trading, particularly in respect of this liquidity universe, if alternatives to lit markets were to be eliminated.

Encouraging competition

- Plato is concerned that moving all below LIS orders onto lit venues significantly reduces competition and would take European equity markets backward rather than forward with the attendant higher costs of trading for end investors.

- A well-functioning market encourages competition and requires multiple venues with heterogeneous transparency, size and latency characteristics. The evolving competition in European equity market structure since MiFID I has driven important innovations such as LIS trading, mid-point execution and closing auction competition that has resulted in improved execution quality through reduced market impact, price improvement and reduced trading costs.

- A reduction in competition undermines the best execution framework by limiting EU investment firms' choices in the most appropriate methods of execution available to obtain the best outcomes for end investors.

Improving Pre-Trade Transparency

- Plato believes that rather than driving all below LIS orders to lit venues to the detriment of the end investor, European regulators should focus on improving pre-trade transparency for market participants through creation of a pre-trade consolidated tape.

- A consolidated European Best Bid and Offer ("EBBO") price for equity and equity-like instruments would provide EU investment firms with the ability to determine optimal trading venues for specific transactions and would form a key part of assessing execution outcomes in the context of the MiFID II best execution framework.

- Post-trade transparency is an important factor contributing to price discovery, and MiFID II has significantly improved post-trade transparency through timely reporting of off-venue transactions. The recent regulatory focus on a post-trade consolidated tape will also provide significant benefits for price formation. In this regard, we would encourage policy makers to adopt a broader view of determinants of price formation, beyond just pre-trade transparency.

Best Execution

- One of the most important aspects of MiFID was the significant enhancement of best execution practices, governance and compliance oversight. These practices highlight that utilising pre-trade transparency waivers through dark MTF and SI trading mechanisms has significantly improved overall trading performance by reducing market impact and achieving price improvement on executions to obtain the best outcomes for end investors that the regulators intend to protect.

Plato Partnership is supportive of the efforts to ensure transparency in Equity and Equity like instruments. However, removal or further restriction of pre-trade transparency waivers in order to move below LIS orders to lit venues would significantly impact the end investor and we believe the end investor is the voice that should have the most weight in these arguments.

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About Plato Partnership Limited

Plato Partnership Limited, a not-for-profit company comprising 29 European buy-side and sell-side member firms, was formed in September 2016 with a vision of bringing creative solutions and efficiencies to today's equity marketplace. The group's key aims are to reduce trading costs and simplify market structure for the benefit of all market participants, and to act as a champion for end investors.

Central to this vision is Plato Partnership's Market Innovator (MI3) that sponsors independent academic research that will identify better ways of executing trades, as well as lowering the cost and improving the quality of the broad range of processes required to support the execution lifecycle. Plato Partnership co-operates with industry providers to implement its research findings into practical solutions for all market participants.

Members of Plato Partnership include:

Allianz Global Investors, Axa Investment Managers, Baillie Gifford, BlackRock, Cedar Rock Capital, DWS Group, Fidelity International, Invesco, Janus Henderson, Legal & General, Liontrust, Norges Bank Investment Management, Schroders, T.Rowe Price, Union Investment.

Barclays, Bank of America Securities, Citi, Credit Suisse, Exane BNP Paribas, Goldman Sachs, Jefferies, J.P. Morgan, Morgan Stanley, RBC, Redburn, Societe Generale, UBS.

For more information, please visit www.platopartnership.com