Association for Financial Markets in Europe

Briefing Note

The health of price formation in European equity markets

July 2022

Executive summary

Competition and choice for better end users' outcomes

AFME members believe that the EU's equity market structure should allow for a framework that permits the existence of different types of execution model which are subject to a well calibrated transparency regime.

EU markets are sufficiently robust under the existing market structure that allows for trades to be executed away from pre-trade transparent venues. AFME note that no evidence has ever been provided to support the notion that price formation is deteriorating and we caution against policies which force trading activity on to lit venues.

Any measures limiting competition and end users' choice risk detrimental impacts to investors as trading strategies would need to conform to a substandard venue offering, leading to worse execution outcomes.

In addition, within the current global context, and the shrinking size of European traded activity relative to other regions, these limitations could further impact the EU's position as a jurisdiction that is open to investors and firms looking to raise capital.

Overview

This briefing note seeks to demystify the notion of price formation and demonstrate the importance of retaining a varied eco-system within EU equities market structure which delivers added value to end investors and issuers.

What is price formation?

Price formation refers to the process of gathering information relating to the assets being traded in a market. This allows market participants to make informed decisions when deciding to buy or sell a given asset.

A common misconception is that pre-trade quotes on lit venues are the only relevant factor when considering price formation. In reality, price formation is the result of various inputs including post-trade reports, news, market sentiment, earnings and other issuer statistics disclosed under issuers' continuous disclosure obligations, among others.

Given the various inputs, the idea that quotes on lit books need to increase significantly, even at the expense of best execution, is a misguided oversimplification of market dynamics. Price formation is determined by investors' interactions based on a wide range of points.

The relevance of price formation within the ongoing MiFIR Review

Several key features of the transparency regime set out under MiFID II/MiFIR are motivated by the unfounded correlation between pre-trade transparency and quality of price. Hence, the stated preference to shift trading activity on to lit venues. This notion has been detrimental to the development of the EU's capital markets and has ultimately harmed investor choice. This narrative seems to also remain at the core of the current MiFIR Review, where interlocutors are now negotiating several key proposals to "enhance" the EU's market structure. These were set out by the European Commission in its legislative proposal, published in in November 2021, including:

- **Use of the RPW -** The European Commission's recent MiFIR proposals seek to further restrict trading on alternative venues by limiting trading under the RPW to trades above 200% of average trade sizes (a figure which is calculated and known as 'standard market size' (SMS)). This proposal is based on the assumption that price formation on EU markets is at an unhealthy level. Worryingly, it continues to support, without any evidence, the need to concentrate liquidity on lit venues ahead of promoting diversity and competition among EU trading venues.
- **Midpoint execution by SIs -** the European Commission has proposed to limit SIs' ability to execute trades at the midpoint (the mid-price between a bid and an offer). Under these proposals, SIs would only be allowed to do so for trades in sizes above 200% of SMS and below large-in-scale (LIS) only if compliant with the tick size regime, and unrestricted for activity above LIS.
- **SI minimum quoting sizes -** the European Commission has suggested that minimum quote sizes for SIs – the minimum size at which an SI is required to stream public pre-trade quotes – should be raised to 200% of SMS. This proposal has received no impact assessment and ignores ESMA's suggestion for the threshold to be applied at 100%.

All of these proposals hold the same goal of forcing trades to take place on lit venues based on an unsupported view that price formation is unhealthy in EU markets. This approach risks diminishing returns for investors who rely on a diversity and competition to ensure that the explicit and implicit costs of executing a trade remain low. AFME therefore opposes the implementation of these changes and calls upon policymakers to re-assess views on price formation which to date have never shown to be unhealthy in the context of EU equity markets.

Non-displayed trading and the health of price formation

Trading on lit venues plays a role in price formation, however it is not always the most appropriate way of trading, and it is certainly not the only contributing factor to price formation. As already noted, price formation is the result of a number of inputs, where pre-trade information (made available by publishing orders to buy or sell a stock) is equally important to post-trade information.

Post trade transparency (which has increased significantly under MiFID II) plays a vital role in informing the market of details of activity that have taken place in a given share. This is particularly critical for trades that are larger in size as it provides valuable information on the price and size at which institutional investors (e.g. pension fund managers) have been willing to trade.

Investors' orders are generally managed in a way which minimises information leakage. This is necessary to protect the order from being exploited by participants utilising high frequency trading strategies and to protect the market from sudden price swings. The solution to this problem has been the creation of mechanisms waiving the requirement for pre-trade transparency. Although trades that take place under these waivers do not provide pre-trade information to the wider market, they are still post-trade reported meaning that the price, volume and time of the trade are published immediately after the transaction is finalised. Consequently, these trades can be considered as contributing to price formation.

AFME values the price formation provided by lit venues (e.g. exchanges) and does not wish to see that undermined. However, there is no evidence to demonstrate that the price formation process is harmed by the use of alternative trading mechanisms. In fact, Aquilana *et al* show that alternative venues complement activity in lit markets "since the trades executed in the dark are based on reference prices determined on the lit exchanges, the overall market's price discovery process is more efficient for each stock traded simultaneously in the dark and lit venues". Furthermore, the authors conclude that trading quality is "furthered by the existence of dark pools operating alongside lit exchanges. It is important that policy makers take care not to eliminate the market quality benefits of dark trading by arbitrarily imposing uniform dark trading restrictions for all stock sizes"[1].

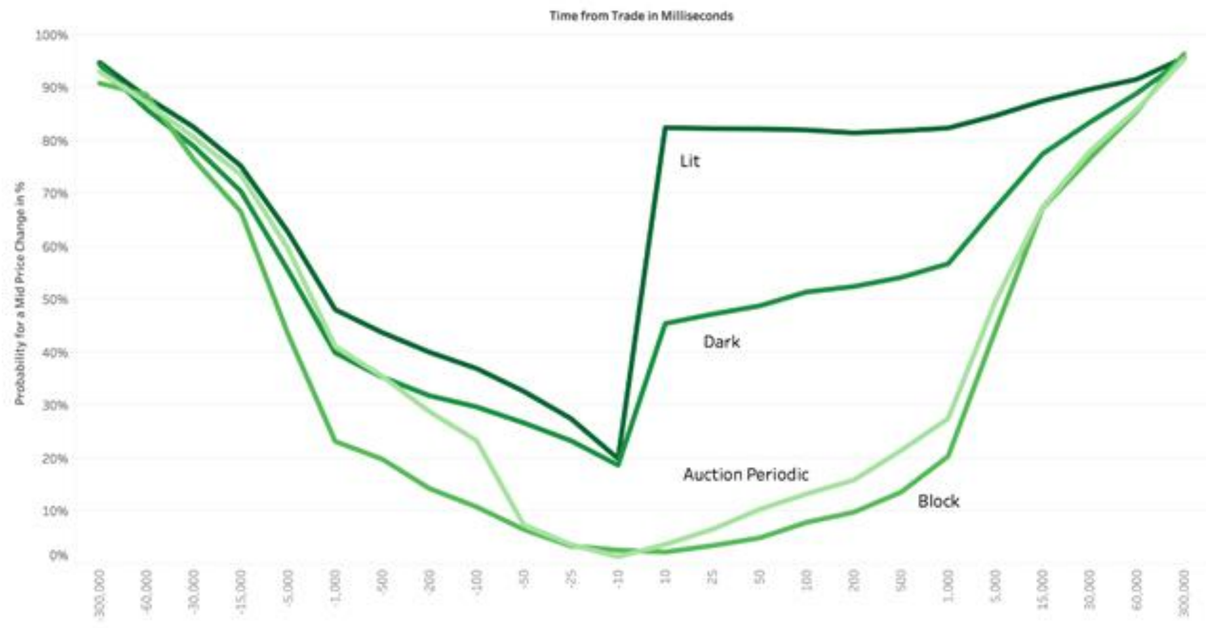
AFME believes that price formation in EU equity markets is healthy and robust. We see no evidence that price formation is under threat however, our concern remains the continued efforts to concentrate liquidity on lit venues will undermine the EU as a place to invest and raise capital.

The value of diversity and competition in EU equity markets

Diversity of execution mechanisms is critical to facilitating a wide range of trading and investment objectives. In particular, active investment strategies often require execution in varying trade sizes and these should be achievable without paying a penalty regarding the cost of execution. The chart below shows the choice facing an investor when attempting to execute a trade whilst seeking to limit the risk of a price movement against them.

The green lines show the probability of price volatility in the milliseconds before and after a trade. The range in the probability of price movement during the lifecycle of a trade demonstrates the importance of a diverse choice in execution venues being made available to investors.

It is clear that trading on lit venues (dark green line) offers the highest risk of price volatility indicating why having the option to trade using alternative execution mechanisms how and where an investor executes a trade, according to investors' specific needs, is a vital feature of a healthy market.



1 Matteo Aquilana *et al*, "Dark trading and market quality - Moderate levels of activity in UK dark pools appear to support market quality in equities", 2017 (https://www.fca.org.uk/insight/dark-trading-market-quality)

Conclusion

AFME members believe that the EU's equity market structure should allow for a framework that permits the existence of different types of execution model which are subject to a well calibrated transparency regime.

Unfortunately, the unfounded assumption that price formation is unhealthy in EU equity markets is set to bring about several damaging changes which will reduce investor choice and limit innovation. Price formation is healthy and bolstered by the existence of a variety of ways in which a trade can be executed and it is important to note that pre-trade transparency on lit venues is not the only contributing factor when thinking about the ways in which prices are formed.

EU equity markets are already less diverse, more complex and consequently less attractive to global investors and issuers. We note that a number of major EU corporates have chosen to list on non-EU markets (e.g. Spotify, BioNTech) in recent years.

Instead of limiting choice and competition, changes to EU equity markets should focus on promoting the Capital Markets Union and the vibrancy of EU markets rather than seeking to artificially support the already dominant position of incumbent, highly profitable exchanges.

AFME Contacts
Sean Barwick

sean.barwick@afme.eu

+44 (0)20 3828 2670

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