Finance for Europe

Association for Financial Markets in Europe

More, rather than less competition is needed in European equity markets

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Diverse and liquid equity markets are the cornerstone of healthy capital markets. Without them, there is less choice and higher trading costs for investors, which in turn negatively affects savers and pensioners. Therefore, it is essential to resolve the current disagreement over where trading should take place in order to ensure best outcomes for investors.

In recent years, Europe's capital markets have undergone a host of changes. Since the introduction of European markets legislation, MiFID II, in 2018, a careful balance has been struck between different types of equity trading mechanisms. According to a new report from economics and finance consultancy, Oxera, 83% of equity trades take place on venues, such as stock exchanges, with alternative trading mechanisms, such as systematic internalisers (which are normally owned by banks or investment firms), accounting for 11% and over-the-counter trades just 6%.

According to this in-depth analysis, alternative trading mechanisms are far from dominating the landscape, but instead provide much-needed choice for investors. Market diversity is important because if trading is concentrated on a particular type of venue it could hamper market competition, reduce choice for investors and keep the costs of trading high. This would also hold back the growth of Europe's primary markets and IPOs, which rely on the deepest secondary market liquidity pools for the highest valuations, making Europe a desirable place to list. For example, in 2020, only €17.5 billion in IPOs took place in Europe, compared to €154.5 billion in the US, including the IPOs of some highly innovative European companies.

Yet, some market participants quite worryingly argue that an even greater share of trades should take place on venues. They call for regulatory intervention to significantly constrain the activities of alternative trading mechanisms and this is likely to limit competition and investor choice. These arguments are driven by the notion that trading on exchanges is more transparent and alternative trading mechanisms are "dark forces". Alternative trading mechanisms, or systematic internalisers are the particular focus of their concerns. Therefore, it is worthwhile taking a closer look at these arguments.

Systematic internalisers are a key part of the market. They are owned by banks or investment firms which use their balance sheets to provide liquidity and take on risk positions to trade with their institutional investor clients directly when clients wish to use them to achieve the best price and minimise trading costs. They also facilitate transactions for their clients at times when other market participants might be unable or unwilling to trade. These functions are particularly important for pension funds or other asset managers who manage the pensions and savings of individuals and therefore are looking for the maximum return on investment and to keep the cost of trading low.

As for transparency, systematic internalisers provide the same pre-trade transparency as exchanges for smaller trades. In fact, many European exchanges themselves are also operating so called "dark pools" that respond to specific investor needs. While the transparency of lit trading on exchanges is undoubtedly a contributor to efficient price formation, so-called "dark trading" - which caters for specific transactions, such as large size trades, creates additional liquidity that otherwise would not be available. In any case, trading on alternative trading mechanisms remains at very low levels and certainly does not dominate the trading landscape. This is evidenced in Oxera's analysis, which paints a clear picture of the current state of liquidity in Europe.

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As Europe looks to navigate its recovery from the pandemic, now more than ever its capital markets need to be diverse and competitive. This goes hand-in-hand with building well-developed primary markets. It would also contribute to the necessary re-equitisation of Europe's economy.

Before looking to adjust equity market structure rules in the EU, policymakers need to have a full understanding of the existing secondary market trading landscape. For this they need to ensure that they have the right data analysis to hand which clearly shows where liquidity lies. Otherwise, Europe's capital markets could be less able to support the post-pandemic recovery in the coming years, and in the longer run could risk losing their global competitiveness.

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