EUROPEAN PRINCIPAL TRADERS ASSOCIATION

Mind the Transparency Gap

Identifying a Wholly Unreported Segment of Addressable Liquidity in European Equity Markets

April 2024

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EXECUTIVE SUMMARY

European equity markets are perceived to be suffering a longstanding liquidity crisis, with reported average daily volume stagnating, particularly relative to the US[1]. This perception has been blamed for declining capital allocation towards European markets and the migration of listings to other regions. Considering this trend, FIA EPTA has identified an entire segment of addressable equity activity in both EU and UK markets that is currently wholly unreported. This relates to hedging activity concerning bilateral synthetic equity exposures traded at-scale on Broker-internal Systematic Internalisers (SIs).

Simple technical changes to the MiFID II Post Trade Transparency (PTT) regime would bring this activity to light, boosting reported European equity volumes so that they better reflect the actual levels of addressable liquidity and economic interest available in European markets today.

A perception of larger, more vibrant *secondary* markets in Europe will contribute to strengthening EU and UK *primary* markets, as market depth and liquidity are key factors for companies considering listing their stock via an initial public offering (IPO). If the real story regarding European equity volumes was clear for all to see, this would present a much more appealing market environment for those seeking to invest and raise capital, supporting economic growth for the entire region.

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Without addressing the transparency gap, incorrect or incomplete conclusions will continue to be drawn regarding the appropriate market structure needed for European equity markets. Moreover, keeping these volumes out of sight will further, and unnecessarily, complicate achieving the goal of a deeper and more liquid European market (targeted in the EU via the Capital Markets Union).

This paper sets out what the transparency gap is, why it exists, and how it can be solved by targeted amendment of the technical MiFID II rules governing post-trade transparency (RTS 1). Addressing the transparency gap will be critical, for while the exact size of the problem is a "known unknown" due to the current lack of reporting, its scale is certainly significant.

[1] For example: In Charts: Why European Stock Markets are in Crisis (ft.com); Deutsche Börse's aborted proposal to Euronext highlights Europe's IPO woes (ft.com); EU Equity Trading Lit Volumes at Record Lows - Markets Media.

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HOW DO INVESTORS TRADE EUROPEAN EQUITIES?

Before diving into the issue, it is important to be mindful that investors prefer, for various reasons, to trade European equities in different ways. Their decisions as to how they want to gain exposure to European equities drive very different transparency outcomes under the current MiFID II rules[2]. The flexibility and choice in how to trade EU and UK equities is a long standing and valuable feature of the European market, supporting investors' ability to meet their investment objectives and best execution obligations. It is, therefore, not any individual trading style that causes the transparency gap; rather, it is an unintended consequence of the current logic of the MiFID II post-trade transparency reporting regime when certain trading styles interact, as we will explore further in this paper.

While there exist many trading options for investors, they can broadly be split into two categories:

1. **Direct investment in shares** (also referred to as "cash equity" or "physical" trading): In this case, the investor is transacting directly in shares gaining all the inherent (voting) rights attached to ownership.

2. **Synthetic exposure to shares:** In this case, the investor is buying or selling economic exposure to shares synthetically via a derivative referencing the physical shares. This can happen via listed derivatives traded on a Regulated Market (also known as Exchange Traded Derivatives), but more commonly will happen via an OTC derivative, such as a Total Return Swap or a Contract for Difference (CFD), traded bilaterally with an Investment Bank or Broker. An investor with such synthetic exposure generally has the same economic exposure to the underlying shares as an investor physically trading those shares (e.g., to price changes and dividends). However, an investor with synthetic exposure will not, for example, have voting rights.

The transparency gap is an unintended consequence of the current logic of the MiFID II post-trade transparency reporting regime

[2] The EU and the UK have substantively the same post-trade transparency regime in relation to this activity.

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The important point to note here is that, regardless of the method by which an investor seeks to have (physical or synthetic) exposure to a share, from the market's perspective, *the effect on price formation* is effectively the same and should therefore have equivalent post-trade transparency. Such post-trade transparency already applies to Exchange Traded Derivatives, where trades are published by the relevant market, but for the far more prevalent practice of investors taking exposure via OTC derivatives, the picture is much more opaque, as we explain below.

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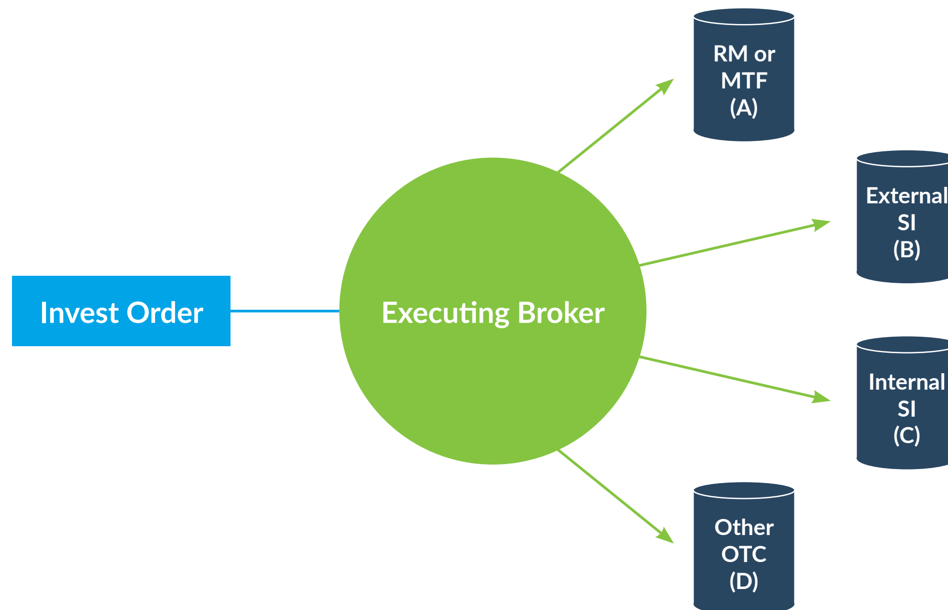
HOW ARE INVESTORS' ORDERS EXECUTED?

The transparency gap is caused not just by the option chosen by investors for accessing economic exposure to shares (physical vs. synthetic) but also by how investors' trades are executed. Virtually all end-investors use a Broker to execute their orders for them (rather than doing this themselves directly on the market). Diagram 1 below sets out the most common routes for an investor's order to be executed by their Broker[3].



[3] We do not include listed derivatives here, given they are directly subject to their own transparency regime under MiFID II.

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Diagram 1: Execution pathways for investor orders

Diagram 1 shows there are broadly four pathways where an investor's order can be sent for execution by an Executing Broker:

A. **RM/MTF**: Regulated Market or MTF[4]

B. **External SI**: Systematic Internaliser not operated by the Executing Broker[5]

C. **Internal SI**: Systematic Internaliser operated by the Executing Broker

D. **Other OTC**: Other forms of bilateral liquidity[6]

The specific pathways used to execute a client order will determine the level of transparency associated with the execution of that order and which will vary widely.

[4] This includes the Primary Listing Market, generally operating a lit continuous market and opening and closing auctions, as well as MTFs supporting various trading methods including lit and dark books as well as periodic auctions.

[5] This includes systematic internalisers operated by other Brokers or Electronic Liquidity Providers (ELPs).

[6] This includes any other Over-the-Counter (OTC) liquidity that may be available. For EU investors, access to this liquidity may be limited by the Share Trading Obligation in some cases.

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THE TRANSPARENCY GAP

Where an investor chooses to physically trade in cash equities, the full transaction will be printed to the market under MiFID II's Post Trade Transparency rules. However, the same is not true in every case where the investor chooses to trade an instrument giving synthetic exposure to shares. While synthetic transactions that execute via a RM/MTF, External SI or Other OTC channel will have the same levels of transparency, critically, those that execute via an Internal SI do not. In other words, not all transactions executed in an Executing Broker's Internal SI in relation to a synthetic instrument will end up being published to the market. Table 1 below sets out the post-trade transparency status for the various execution scenarios. We explain this in more detail in the next section.

Table 1: Post-trade transparency status for various execution scenarios

Order Type	Execution Pathway	Post-Trade Transparent	Trade Published Via (with venue MIC)
Physical/ Cash	**A** RM/MTF	Yes	RM/MTF
	B External SI	Yes	APA (MIC: SINT)
	C Internal SI	Yes	APA (MIC: SINT)
	D Other OTC	Yes	APA (MIC: XOTC) or RM/MTF (NT Waiver)
Synthetic	**A** RM/MTF	Yes	RM/MTF
	B External SI	Yes	APA (MIC: SINT)
	C Internal SI	No[7]	N/A
	D Other OTC	Yes	APA (MIC: XOTC) or RM/MTF (NT Waiver)

[7] Internal Broker SIs can be quite complex and certain investor orders may in practice interact with multiple types of liquidity, some of which may result in a trade being published.

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WHY ARE CERTAIN TRADES NON-REPORTABLE?

As we noted above, when an investor chooses to obtain economic exposure to a share via a synthetic instrument, they enter into an OTC derivative contract with the Broker taking the other side of the position. i.e., where the client wants long exposure to a stock via a synthetic instrument, the Broker will have an equal and offsetting short position in the stock. (And vice-versa: where the client wants a short exposure to the stock, the Broker will have a corresponding long position). The Broker will usually systematically hedge this position by buying (or selling) the relevant stocks. The Broker will ensure its hedge position precisely matches the investor's exposure in order to effectively manage risk. The Broker will also use the price established via the hedging trades (amongst other factors) to price the derivative for the investor.

Diagram 2: Synthetic transaction between Broker and investor

The hedging transactions in shares by the Broker will be executed in line with best execution guidelines and according to the investor's instructions (due to their connection with pricing the derivative by the Broker). However, they will nonetheless remain the principal hedging trades of the Broker, i.e., undertaken *for its own account* rather than on behalf of the investor:

- In the scenario that these hedging trades by the Broker happen via execution pathways A, B or D, i.e., where they interact with third party liquidity either on a trading venue or OTC, the trades and volume will still be printed to the market in line with the MiFID II PTT framework.
- **However, if the Executing Broker chooses to execute its hedge inside its own Internal SI (pathway C), e.g., against another hedge (of a synthetic instrument) in its own SI, the resulting "trade" relating to the investor's order has the Broker as both the buyer and the seller, and as such, there is no trade that is recognised under the MiFID PTT framework for printing to the market. This is how the transparency gap comes into being.**

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The scale of this non-reportable activity is known to be material but is unfortunately unquantifiable at this stage due to being unreported. Bringing these volumes into the scope of the MiFID II post-trade transparency framework will, therefore, give a more accurate and (given the significant size relative to the other execution scenarios) a more positive picture of European equity volumes

AN EXAMPLE OF UNREPORTED SYNTHETIC EQUITY TRADING

Let's take an example to help make things clearer. We will assume to have two clients of an Executing Broker: Client 1, who physically trades in European shares, and Client 2, who trades synthetically via CFD.

Both clients send orders to the Broker to buy 1 million EU or UK shares such as Total S.A. or Vodafone PLC and the Broker works their orders via a VWAP algorithm over the day. In Table 2 below, we set out a realistic theoretical scenario and show the resulting transparency associated with the trading activity.

Table 2: Example of unreported synthetic equity trading

Execution Pathway	Percentage of the Orders Completed	Volume Printed Client 1's Order (Physical)	Volume Printed Client 2's Order (Synthetic)
RM/MTF (A)	**55%**	550,000 shares	550,000 shares
External SI (B)	**5%**	50,000 shares	50,000 shares
Internal SI (C)	**39%**	390,000 shares	0 shares
Other OTC (D)	**1%**	10,000 shares	10,000 shares
Total	**100%**	**1,000,000 shares**	**610,000 shares**
The Transparency Gap		**0 shares**	**390,000 shares (39%)**

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In this example, 39% of the synthetic order of Client 2 was internalised by the Broker's own Internal SI (Pathway C), with the corresponding hedge trades by the Broker also taking place within the same Internal SI, and with these hedge trades then executing against further Broker hedges for other clients' synthetic orders. As a consequence, the resulting "trade" via the Broker's Internal SI relating to the order of Client 2 has the Broker as both the buyer and the seller and, consequently, nothing will be reported.

> The unreported nature of this activity is significantly shrinking the apparent over-all trading interest in European equities.

It is clear that in a situation where Executing Brokers internalise high proportions of their hedging trades for investors' orders seeking synthetic exposure to European shares, the unreported nature of this activity is significantly shrinking the apparent over-all trading interest in European equities. However, with minor technical adjustments to the MiFID II post-trade transparency regime, these trades would indeed be printed to the market, thereby resulting in a significant and immediate increase in published European share trading volumes.

SO, WHAT NEEDS TO CHANGE?

In order for these substantial volumes to become visible to the market, only minor adjustments to the post-trade transparency requirements would be required. The simple solution would be that, if an Executing Broker accesses its own inventory (via Internal SI) to fulfil all or part of the hedge to a synthetic transaction, then a trade report should be made giving the same post-trade transparency as if the Broker had fulfilled the hedge from an external source, such as a Regulated Market/MTF or External SI.

These changes could be made by a simple amendment to RTS 1, which is the regulation setting out the technical detail of the MiFID II transparency requirements for shares and equity-like instruments.

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CONCLUSION

A gap exists in MiFID II's post-trade transparency rules causing equivalent investment decisions by different investors to result in substantially different transparency outcomes. This trading activity (and the economic interest in European equity markets that it reflects) is not just obscured or hard to find, it is completely missing. As a consequence, European share trading volumes are being perceived by the market (including global investors and issuers) as being significantly lower than they actually are. No one has the full picture. When viewed in combination with the fragmented nature of Europe's trading landscape and the lack, as of yet, of a Consolidated Tape, it becomes easier to see why investors and issuers are shunning European markets in favour of other global financial centres.

Regulators in the EU and UK need to update the relevant post-trade transparency rules RTS 1.

Regulators in the EU and UK need to take the opportunity presented by the imminent establishment of a Consolidated Tape for shares and ETFs to update the relevant post-trade transparency rules RTS 1, so that they capture the full scope of share trading activity in Europe. Without this, Europe risks being left behind.

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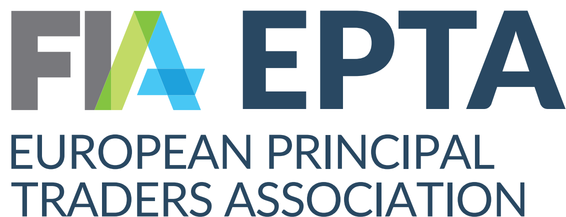
www.fia.org/epta *and* www.wearemarketmakers.com



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