FESE Response to ESMA Consultation Paper 'Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps' – ESMA/2012/580

1. Introduction

The Federation of European Securities Exchanges (FESE) represents 46 exchanges active in equities, bonds, derivatives and commodities through 21 full members from 30 countries, as well as 7 observer members from European emerging markets. FESE is a keen defender of cross-border competition and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE members operate Regulated Markets (RMs), which provide both institutional and retail investors with transparent and neutral price-formation.

FESE members are glad to have the opportunity to contribute to ESMA's consultation. FESE supports efficient, fair, orderly and transparent financial markets that meet the needs of well protected and informed investors and provide a source for companies where to raise capital and for investors to hedge their portfolios.

Below you will find our response to some of the questions included in the discussion paper. Our response focuses on those provisions that have an impact on regulated markets.

2. Executive summary

FESE generally believes that most of the measures proposed by ESMA are reasonable and in line with market standards. We believe however that the results of this consultation are likely to have an impact on further regulation (e.g. MiFID II). Therefore we would like emphasize the following points:

- All market makers should effectively participate to enhance market liquidity.
- The calibration of the programmes' criteria is essential but depends on the market structure, the market participants, and the asset's liquidity and should therefore be left as much as possible to the discretion of the trading venue.
- There should not be a narrow definition of market making.
- Market markers play a different role in smaller, regional and less liquid markets than in large and liquid markets.
- There are good examples of existing market making models in Europe that have evolved over the years in cooperation with local market participants and local competent authorities. These models are tailor-made for the peculiarities of the regional markets in question and should be taken into consideration by the ESMA guidelines as otherwise there would be serious implications for existing market structures.

In our responses to the specific questions below we make these points in further detail.

3. Responses to specific questions in the consultation

Section II: Background and Introduction

Q1: Do you agree with the above approach regarding the definition and scope of the exemption for market making activities? Please, explain.

We believe that a notification period of 30 days with respect to the use of the exemption is far too long and not workable in practise. A period of 30 days represents an enormous extension in comparison to current business practise.

Section V.II. - Principles that should apply when "posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market" (Article 2(1)(k)(i))

<u>Question 4</u> - Do you agree with principles applicable to persons carrying out market making activities in accordance with Article 2(1)(k)(i) of the Regulation? In your view which of the two options in paragraph 44 should apply to quotes entered when carrying out market making activities? Do you see another alternative to the two options proposed? Please, provide explanations.

FESE agrees with the principles proposed and, due to the structural differences between individual markets, suggests taking further parameters into account. These parameters should be based on the needs and specifics of the individual stock exchanges and should include variables such as volatility, unwinding period, free float capitalisation, etc. Market makers generally offer binding bid, and ask prices (quotes), on a continuous basis under certain criteria. Market makers usually include securities trading firms, banks and brokers. Exchange members that are not allowed to provide services for third parties (clients) cannot act as market makers.

The 'presence' criteria for quotes should be considered as market-making should be based on a maximum spread rather than on the average spread for the instrument. A maximum spread measure would give the flexibility necessary to adapt to the different phases of an instrument's life cycle

The venue on which the instrument was first admitted to trading should be the one setting the maximum spreads (closer link to issuer/instrument than any other entity, more accurate view of trading in the instrument); this threshold would then be applicable across the EU

Section V.IV. - Qualifying criteria applicable to activities under Article 2(1)(k)(i)

- **The comparable sizes of orders**

<u>Question 6</u> - Do you agree with the qualifying criteria for the comparable size of orders? Please explain.

ESMA proposes that the size of the orders issued in the market making capacity is assessed in consideration of the average trading size (ATS) for the said financial instrument on a specific venue. However, we believe that ESMA fails to provide information on the frequency of this assessment.

In the case of some FESE members, the minimum quoted size is linked to the average order size of the instruments included in the respective liquidity class and is reviewed periodically (i.e. on a weekly basis). As pointed out above, the structural differences between individual markets do not allow such a one-size-fits-all approach.

“Comparable” should therefore be understood as posting bid and ask quotes of relative size to one another, as implied in the level 1 text, and not as a requirement for each quote to be of a minimum size per se.

Finally, ATS should be in relation to order book business, excluding block trades etc

- **The competitive prices of orders:**

<u>Question 7</u> - Do you agree with the qualifying criteria for competitive price of orders? Please explain.

FESE members are of the opinion that the requirements for market making activities in liquid shares should not necessarily be more demanding than those in less liquid shares. However, there should be less stringent requirements for less liquid markets in general.

<u>Question 8</u> - Which option do you favour? Please, justify.

FESE members are of the opinion that it should depend on the type of instrument. In general, further parameters should be taken into account to reflect the structural differences between exchanges, especially the specifics of less liquid markets.

For derivatives, FESE would favour an alternative option in which a maximum spread is defined. Spread classes are usually defined based on the price level and the liquidity of the instrument or the underlying instrument.

This approach gives the possibility to the market marker to propose asymmetric quotes and therefore to manage imbalances better.

This approach is preferred to option 1 and option 2. Some market makers still quote manually and a dynamic spread requirement as defined by option 1 would require an automatic solution is developed by these market makers. Our suggested option of a maximum spread avoids permanent updates on quotes with positive effect on system load. The maximum spread we agreed on with our market makers considers levels of liquidity i.e. the higher the liquidity the tighter the spread requirement due to lower risk on market maker side (e.g. whether the option is in the money, at the money or out of the money).

For cash equities, some members believe that option 2 would be preferable. Average price is a much more accurate measure and spreads are based on prices in any case. Some other members believe that the above option in which a maximum spread is defined would be the preferable one.

- **A regular and ongoing presence on the market:**

<u>Question 9</u> - Do you agree with the qualifying criteria for ongoing presence on the market? Do you think different criteria should apply when conducting market making activities in sovereign debt? Please explain.

FESE agrees with the proposal that market making activities should, on a monthly basis, be undertaken for a minimum of the overall trading time on a given financial instrument. 90% might be seen as difficult to achieve for market makers especially for instruments other than shares, which tend to be less liquid. The proposed 90% figure is therefore unacceptable for less liquid markets.

More flexibility is needed on the presence time criteria. Measures should be adapted the liquidity, life cycle and market model of each instrument. A presence of 90% of the overall trading time on a monthly basis cannot be required from market makers in less liquid instruments, particularly some derivatives. Moreover, a trading venue should have the ability, with a market maker, to have high-level and low-level demands on specific products. A one-size-fits-all approach would not work.

In some equity markets, the minimum participation is set to at least 65% of effective trading time across all products. The effective trading time is the time between the start of continuous trading and the start of the closing auction excluding the time of intraday auctions and volatility interruptions. On derivatives markets, the time presence is more complex to evaluate. Indeed, for options, it is defines differently, as different strikes and maturities come into play. Market makers typically insure coverage of 85% of the overall trading time in x out of y strikes (e.g. 7 out of 15) in e.g. the first 8 expiries.

Section VI – Exemption process

- **Notification of intent**

<u>Question 13</u> – Do you agree that the above information needs to be provided in the notification form? Should historical data be also provided with the notification form? Please, provide justifications.

Notifications should be made for a class of options or for all the maturities of a future contract rather than on an instrument by instrument basis.

- END -