PUBLIC RESPONSE TO ESMA CONSULTATION ON PROPOSED AMENDMENT TO MIFID II RTS 1

Optiver, Flow Traders, and **Quantlab** are grateful for the opportunity to input into ESMA's consultation on a proposed amendment to MiFID II RTS 1. We are principal trading firms that deal on own account in a wide range of financial instruments traded on trading venues across the EU and beyond.

Q1: Do you agree with ESMA's proposal to clarify that SIs' quotes would only reflect prevailing market conditions where the price levels could be traded on a trading venue at the time of publication?

We wholeheartedly agree with the spirit of MiFID II to promote transparency and ensure fair and orderly markets. Under MiFID II, the expansion of the Systematic Internaliser (SI) regime to non-equities captures much more over-the-counter (OTC) trading activity. We welcome this change as we believe that this is a step toward increased transparency.

However, we are concerned the internalisation of order flow may undermine the efficiency of price formation on trading venues. In the spirit of MiFID II/MiFIR we believe order flow should primarily be executed on trading venues.

The absence of a true level playing field between the SIs and trading venues may be detrimental to the EU market structure as it may cause order flow to move away from trading venues to SIs. We have been deeply concerned about potential evolutions in EU market structure relating to the implementation of the SI regime for the past year, in particular based on indications that there will be ***a very widespread use of the SI regime, including for liquid shares trading.***

In our view, the main reason this is emerging is the number of incentives inherent to the SI regime, which together ensure no level playing field for transparent venues. The most material 'advantage' SIs have is that they are not required to quote in compliance with the tick sizes of shares, depositary receipts, ETFs, certificates and other similar financial instruments. SIs will thus easily be able to price improve as compared to public markets by potentially infinitesimal amounts – and transact inside the best bid/offer – even in small sizes.

While price-improved transactions will offer a lower explicit transaction cost to buy-side/other clients in *a specific SI transaction* (making SIs the *de facto* destination of choice for Smart Order Routers (SORs) seeking best execution) in the long term, this will come at great cost for the public markets' role in central price formation. **If SI trading grows to the extent that some predict, implicit transaction costs will by definition rise as internalisation always harms the quality of the public markets on which it relies.**

This harm will ensue due to the fact that SIs would be able to offer better pricing by free-riding off the prices provided by transparent liquidity providers active on the lit book. In other words, SIs can use the on-exchange best bid and offer set by market makers as reference prices, which SIs can then (marginally) improve, without genuinely contributing to price formation.

With regard to the tick size for shares it is especially bizarre that there is a discrepancy between SIs and regulated markets/MTFs given all three are treated "on par" by MiFID II/MiFIR for the purpose of meeting the shares trading obligation.

ESMA's recent proposal to restrict an SI's capacity to price improve to 'meaningful price improvement' (i.e. price improvement of at least one tick compared to the best bid and offer on the reference venue) is a step forward as it tries to address the unfair advantages of the SI regime. However, we make two observations:

- We support a further reaching proposal in which SI quotes are considered to reflect the prevailing market conditions where those quotes show a *price improvement* of at least one tick compared to the best bid and offer on the reference venue. If SI quotes reflect the best bid and offer on the reference venue, we believe preference should be given to the most relevant market in terms of liquidity as determined in accordance with Article 4 RTS 1 for that financial instrument, except if it would serve similar purposes as those referred to in Article 17(3) of MiFIR. In our opinion, this further reaching proposal would meaningfully contribute to the efficiency of price formation and would be in line with the spirit of MiFID II.

- ESMA's proposal, when made, will not solve the level playing field issue as it would only apply to SI quotes for transactions up to "standard market size". Above standard market size, nothing restricts SIs' ability to price-improve in MiFID II/MiFIR.

Given SMS is often very low – pan-European transaction sizes for shares were approximately EUR 5,930 in October 2017, which means most shares in January 2018 will be standard market size at EUR 10,000 – we remain deeply concerned that a large number of SI transactions would not have to comply with the tick size regime unless a more fundamental "fix" is considered. We believe, even with this important change, the impact on the quality of Europe's public markets will remain potential very high.

In ESMA's own words, SIs are competing with trading venues over order flow. Therefore, we agree it is important for ESMA to provide for a level playing field. To distinguish between trades above or below SMS, or to treat trades on an SI different from those on a trading venue, would be detrimental to the EU market structure and may affect liquidity on trading venues.

Question 2 – Do you agree with the drafting amendments described above?

Yes.

Further, given SIs will de facto act as public venues, we believe the RTS provisions on post-trade transparency for SIs should be strengthened. SIs are execution venues that were given the regulatory 'privilege' to meet the trading obligation; we believe that means their requirement for real time publication of transactions should be equal to and enforced in the same (microsecond) manner as trading venues.

ESMA demonstrated awareness of this problem in its 03/10/2017 Q&A by stating that "ESMA expects that trading venues and investment firms, in particular SIs, that use expedient systems publish transactions as close to real time as technically possible. In particular, since SIs are competing with trading venues over customers' order flow, it is important to provide for a level playing field. Therefore, trading venues and SIs using similar technology and systems should process transactions for post-trade publication at the same speed."

A Q&A is very helpful guidance – but of course does not have the same force as law as more binding measures. We would like to see ESMA take this opportunity in reviewing RTS 1 to introduce more robust transparency requirements to the RTS itself to avoid any regulatory divergence emerging.

Flow Traders is a leading global technology-enabled liquidity provider, specialized in Exchange Traded Products (ETPs). Through its trading desks in Europe, the Americas and Asia, it provides liquidity across all major exchanges, globally, 24 hours a day. Flow Traders Europe's operations are headquartered in Amsterdam.

Optiver started business in 1986 as a single trader on the floor of Amsterdam's European Options Exchange. Today, Optiver is a leading global electronic market maker, focused on pricing, execution and risk management. Optiver provides liquidity to financial markets using own capital, at own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.

Quantlab is a dynamic, technology-driven firm supporting a large-scale quantitative trading operation across a wide range of global financial markets. Founded in 1998 in Houston, Texas, Quantlab has long been considered is considered a leader in the industry supporting global growth of electronic markets. Quantlab's European trading operations are based in Amsterdam.