

# Non-addressable liquidity and price formation

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## 1. Introduction

The discussions around the concept of non-addressable liquidity as referred to within Article 23 MiFIR on the share trading obligation (STO) have ramifications for market data quality but also equity market structure. Because stakeholders are presenting views that can significantly differ from each other, FESE would like to clarify some aspects relevant to the discussion and warn against the consequences of conditioning decisions on the EU market structure to a definition of non-addressable liquidity.

The concomitant case of non-price forming transactions, which cover not only non-addressable but also addressable liquidity, touches upon core aspects of the EU regulation through the STO, transparency requirements, and the consolidated tape. In this context, we believe that the regulatory initiatives from ESMA<sup>1</sup> will contribute positively to the effort of the industry to bring more transparency and data quality to EU equity markets. Because they should allow in fine for better understanding of the activities and transactions executed in the EU, we believe efforts shall concentrate on those initiatives before an additional classification of transactions is proposed in the EU, which is not based on a regulatory requirement.

## 2. The significance of non-addressable liquidity

While there is a lot of debate currently on non-addressable liquidity not only in the context of the STO but also in the context of transparency and the consolidated tape, we would like to caution against the idea that addressable liquidity is in fine limited to central limit order books hence ringfenced to pre- and post-trade transparent transactions and trading venues' trading hours, excluding OTC, most of SI activity, and potentially dark trading. The notion of addressable liquidity is not about the place of execution and is not limited to multilateral venues. Such an overly simplified view risks major unforeseen consequences on equity market structure: where MiFID II/MiFIR looked at increasing market transparency, an unjustified definition of non-addressable liquidity could be at odds with this main objective and question the concept of an efficient price discovery process.

Whilst in this debate it is important to recognise as well the distinction between price-forming and non-price-forming transactions, addressable liquidity refers to the interactive nature of liquidity and encompasses both categories.<sup>2</sup> Likewise, mixing technical transactions, non-pre trade transparent trades, and trades without an economic trading interest is incorrect.<sup>3</sup> For example, a significant number of non-price forming transactions

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<sup>1</sup> ESMA, “Consultation Paper on the Review of RTS 1 (Equity Transparency) and RTS 2 (Non-Equity Transparency)” (Paris, 2021).

<sup>2</sup> ESMA.

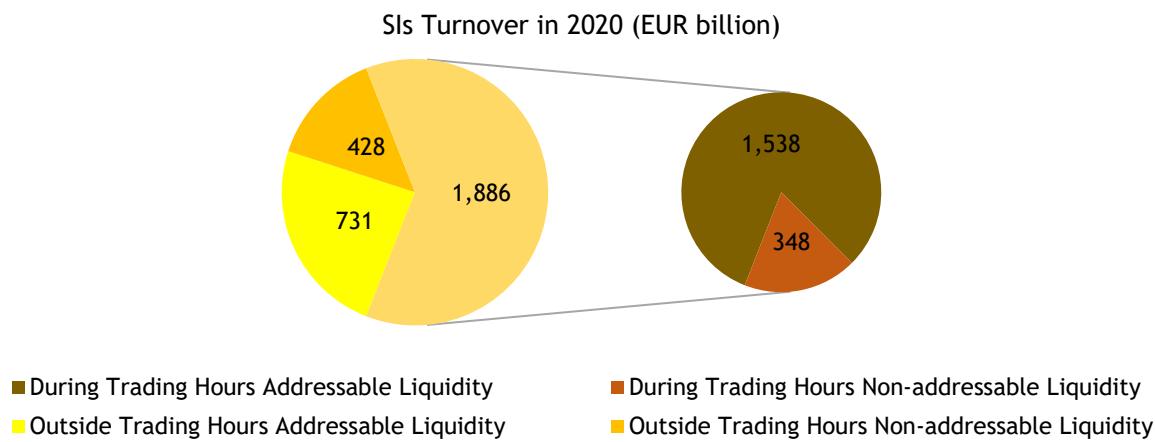
<sup>3</sup> See Oxera, “The Landscape for European Equity Trading and Liquidity” (Oxford, 2021). for an example of this error. See also Liquidnet, “Liquidity Landscape,” July 2021.

(like those executed under the negotiated transaction waiver) are addressable, and would even be price forming if executed on a trading venue. Trades can be identified as addressable liquidity regardless of whether conducted OTC or in an SI.

Furthermore, excluding trades occurring outside of trading hours wrongly assumes that the entirety of those trades has a non-addressable nature. The underlying justification seemingly is that trades outside of trading hours would constitute technical transactions that have not been flagged as such. This however ignores brokers' market-at-close products including SI-at-close services and could imply that transactions during trading hours are flagged wrongly as well.<sup>4</sup> Other transactions like inter-affiliate trades and internal crossing network executions should also be carefully considered before regarding them as non-addressable by default.

Finally, in view of AFME's recommendation<sup>5</sup> that a significant proportion of large-in-scale (LIS) trading should be classified as non-addressable, it should be underlined that the LIS waiver exists precisely to reduce market impact - technical trades and large trades should not be equated.

As an example of these issues, based on data from the provider Big xyt and the current flagging under MiFIR, we can observe that non-addressable trades constitute a significant fraction of SI trading and they should not be overlooked.



Source: Big xyt

### 3. Conclusion

FESE would like to highlight that in the debate around non-addressable liquidity, improving data quality and the flagging of transactions, and in particular allowing the identification of technical trades, is essential. Whilst there is no need for a regulatory definition of addressable liquidity, streamlining the framework where there are inconsistencies is necessary to ensure a clear and harmonised understanding across the EU. This would be the case, for example, in connection with non-price forming transactions and Article 23 MiFIR and RTS 1 Articles 2, 6, and 13 and RTS 22 Article 2. At the same time, the impact of any proposed changes on the transactions excluded from post-trade transparency should be factored in. This topic will also have to be considered in the context of the STO as well as the consolidated tape, given that the design of a consolidated tape could be impacted by the type of trades under its scope.

<sup>4</sup> Tim Cave, "After Hours: The Rise of Europe's Closing Auctions," 2019.

<sup>5</sup> AFME, "Understanding the Liquidity Landscape in European Equity Markets" (London, 2020).

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