MIFID II / MIFIR REVIEW PRIORITIES

ROBERT OPHÈLE

Chair - Autorité des Marchés Financiers (AMF)

MiFIR review: priorities for improving EU markets structure and transparency

In November last year, the European Commission published its much-awaited proposal reviewing the Market in Financial Instrument Regulation (MIFIR). The aim of the review is to enhance transparency and increase competitiveness of European markets; in that perspective, the creation of consolidated tapes on main asset classes would be a key deliverable. The European Securities Markets Authority (ESMA) has provided many advices on possible avenues of reforms in these areas.

We should first recognize that it is indeed very challenging to find the right balance between measures enhancing transparency and those favouring liquidity or between lit and dark trading ; it is rather tricky to adapt the trading rules in order to have the most efficient price formation mechanisms, to rightly implement the best execution principle, and ultimately to ensure a level playing field between service providers located in thirty different countries and supervised by thirty different national authorities but proposing their services Union-wide.

The discussion on these issues has been going on for a long time and should be regularly re-opened, sometimes triggered by trading innovations. We should remain modest in these matters; there is no ultimate regulatory framework. Obviously, the review of MIFIR will not close all the issues but the European Commission proposal, carefully drafted, goes prudently in the right direction.

Who could pretend that a consolidated tape providing, in a first step, almost real-time post-trade data for shares would be irrelevant when we have currently around one hundred and fifty trading venues in the European Union, where one could trade equities? There is a strong public good factor behind such a project and if, despite the mandatory contribution feature introduced in the European Commission proposal, there is no commercial solution popping up one should think to a public solution and indeed ESMA could be a fall back worth exploring.

At some point, the European Union should move and rapidly deliver and the time has come.

How could we support payment for order flow in a single market where best execution remains a rather vague concept enforced by thirty different national competent authorities? Obviously if we had a single supervisor in the European Union or a requirement to provide a very precise, trade-by-trade, proper justification of best execution, a ban of payments for order flows (PFOF) would be much more debatable. In the current circumstances, when we observe a surge of "neo-brokers", which are very welcome when they attract more retail to financial markets, a ban is the most appropriate approach.

How could we have a Capital Markets Union if we accept that deferrals for post-trade bond transparency requirements could vary from one member state to another?

One could certainly have been more ambitious in this review, for example limiting Systematic Internalizers perimeter to Large In Scale trades or increasing the transparency of public debt markets; nevertheless, at some point, the European Union should move and rapidly deliver and the time has come.

When devising the most appropriate framework, one should also take into account the competitive angle, specifically at a time when the United Kingdom is also reviewing its wholesale market regulatory framework. The issue is especially sensitive for bonds where we do not have trading obligation and where the market is more global and more wholesale by nature. While reviewing the patchwork of types of possible deferral criteria – such as transaction size, rating (high yield or investment grade) ...- coordination with the United Kingdom's authorities should therefore be highly encouraged in order to be as aligned as possible.

MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs - European Parliament

MiFIR review: focus on transparency and a level playing field

The Covid-19 crisis has put European financial services market structure to a test. Particularly, in the early months of the pandemic in 2020, we have witnessed extraordinary high levels of volatility in nearly all asset classes. Overall, European markets have coped well during this stress test and have shown their resilience. Regulated markets have played a big part in that. We have seen that in times of high uncertainty, more trading volume goes to regulated markets as safe, transparent and robust trading venues where core price formation takes place and where there is ample liquidity. Transparency and liquidity are highly appreciated by all market participants, as it is a crucial precondition for financial stability and efficient markets.

While the European Union's financial markets have passed the Litmus test of the Covid-19 crisis, the EU's market structure is far from perfect. The reforms introduced with the original MiFID II and MiFIR have also had some undesirable side-effects such as the growth in off-exchange trading and the growing number of Systematic Internalisers (SIs) that do not help the price formation process. As a result - and contrary to the intention of MiFID II - the share of price-forming lit trading activity has decreased to the detriment of issuers and investors alike. The reason for this is arguably that the playing field in between venues is uneven in many areas. The review of MiFIR should attempt to remedy the existing market structure issues, level the playing field and raise overall levels of transparent trading significantly.

The proposal by the European Commission for a revision of MiFIR that was presented as part of the Capital Markets Union package is a good starting point for addressing the issues, but in many instances falls short of what needs to be done. The Commission for example suggests extending the minimum public quoting obligations for Systematic Internalisers to twice the standard market size. While this is a clear improvement over the status quo, there is good reason to go further and increase the thresholds significantly, possibly even up to the large-in-scale waiver threshold. The Commission proposal is simply too timid here.

The review of MiFIR should level the playing field and raise overall levels of transparent trading.

Waivers themselves are also an area that require another critical look. The current regime features several different waiver types as well as the infamous double volume cap. Overall, this results in a regime that is overall very complex, yet offers too many avenues for circumvention that many market participants are skilful to exploit. Simplification of the waiver regime is therefore the order of the day. The European Commission in its MiFIR proposal attempts that, but is not radical enough. While the Commission proposal rightly attempts to get rid of the double volume cap (and replaces it with a single volume cap) and tinkers with the minimum threshold trade size for the reference price waiver, a more comprehensive approach would have been worthwhile. Such a more radical approach would have simplified the entire waiver regime by reducing the waiving possibilities to only the large-in-scale waiver thus increasing overall transparency levels in the market.

Lastly, the Commission proposal also moves into somewhat unexpected territory by suggesting to ban the controversial practice of payment for order flow that has risen to prominence in early 2021 in the context of the Game Stop trading frenzy. While business models based on payment for order flow certainly raise legitimate questions in relation to conflicts of interests, best execution, cost transparency and compliance with the inducement regime, banning the practice seems to be the nuclear option. After all, we have found ways to deal with such conflicts of interests in less intrusive ways in other pieces of financial services legislation before.

Business models based on payment for order flow that are often utilised by so called neo brokers to offer free or very low-cost trading can be credited with democratising access to financial markets to broader range of retail investors, which very much matches the ambition of the Capital Markets Union. However, we need to make sure that retail investors are adequately protected when accessing financial markets.

Right now, there seems to be a noticeable mismatch between the investor protection provisions applied by neo brokers and those by traditional intermediaries. However, looking into such aspects of the level playing field should be a topic for the upcoming retail investment package and the revision of MiFID rather than the MiFIR review.

MARTINA TAMBUCCI

Head of International Relations Office - Commissione Nazionale per le Società e la Borsa (CONSOB)

Transparency versus competition

MiFIDI made the choice to increase the level of competition among execution venues in the Union as a way to curb the costs of trading. The consequent fragmentation effects were anticipated by accepting transparency as a compensation measure to grant a fair price discovery process (as symbolically expressed by the equation that follows).

Competition is to trading costs reduction as transparency is to fair price discovery

A way to assess the measures under the current review package is to check the terms of such an initial paradigm with a view to verify whether it still holds true. MiFID II already attained to a partial rethinking of the believe that the proliferation of execution venues would have only had positive outcomes, which led to the introduction of the share trading obligation along with the derivatives trading obligation. After some more years passed along, there is even more room for re-consideration of all the terms of the equation.

At the time of MiFID I, the objective was to catch up to the lower costs for both trading and post-trading in the US internal market. However, the expectation was not much in terms of competitiveness vis-à-vis other outside financial markets but rather to let European investors, in the internal market, to benefit of lower prices and better investment choices, as well as to improve the channelling of financial resources to the real economy. This is still at the heart of the EU vision, as testified by the CMU Action Plan. However, whichever the efforts to create a sound and united capital market of a European dimension, this cannot be dealt with in isolation but rather needs to be put in a wider perspective.

Competition primarily occurs between EU and the rest of the world and not just among execution venues in the EU. The projection of the EU in the international landscape changed significantly as result of two major factors: Brexit and the digital era. Brexit unveiled the actual threat of an important financial market so close to Europe, not only geographically but in the way it is framed and governed. The digital era made clear that "no place that far".

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Transparency is a much relevant term of the equation above and MiFID II already reached a difficult balance amid several concurring goals. Some shortcomings or inconsistencies in the transparency regime may be fine-tuned in light of the experience of the last four years and the changes in the market structure occurred in the meanwhile as an effect of the MiFID II implementation. However, additional transparency, if not adequately calibrated, particularly for certain asset classes, may lead to higher costs (not just administrative), which may in turn negatively affect the competitiveness of the EU markets.

In other words (see the following equation), to keep costs of transactions low it is important to realise the consolidation of transparency data, awaited since a long time and meant to improve the price-discovery process. At the same time, transparency should be set to stay at a level capable of not hampering competition of the EU as a whole.

CTP is to trading costs reduction as transparency is to competition

All efforts should be put to ensure that a proper consolidated tape could emerge. The EC has been looking into the experience of some other developed financial markets and all involved aspects have been considered, with a view to grant the success of the initiative. Should this not be sufficient, the solution of empowering ESMA to realise such an important function seems the most rational one, also in light of possible synergies with the creation of a European single access point (ESAP), should this be handled also by ESMA. That said, the proposal is not neutral in terms of potential impacts for market data providers and EU operators and therefore the challenge for the EU co-legislators is once again to find the right balance between the feasibility and success of the project and the competitive instances. Attention should also be given on how to implement such projects in technical terms. The precedent of the European Financial Transparency Gateway (EFTG), which essentially makes use of the blockchain technology, is an interesting one. Such a choice could make the realisation time longer but would certainly contribute to an additional aim: that of carrying Europe into the digital era.

Finally, in order to make the most of a fair price discovery process and of competition at the level of execution venues, it is important to avoid any undue influence, such as compensation towards investment firms for directing the orders received to a particular market maker or exchange. The proposed ban of the so called payment for order flow (PFOF) somehow represents just a clarification aimed at giving legal certainty in a context in which it was dubious - as left to interpretation of existing rules on conflicts of interest, inducements and costs and charges - whether such practice were legitimate or not.

CLAUDIA GONZALEZ CABANILLAS

Executive Director, Regulatory Affairs EMEA - JP Morgan

Keeping EU Capital Markets at the core of the MiFID II Review

This year will be another milestone year for the development of market regulation in the EU. The European Commission recently published its legislative proposal on the MiFID II Review, which aims to empower all investors, in particular smaller and retail investors to access the market, and help increase market liquidity.

It will be important for co-legislators in the European Parliament and Member States to focus on further increasing the attractiveness of the EU capital markets and putting in place a regime that is flexible enough to face any future adverse market conditions. The MiFID II Review can achieve this by continuing to support a wide diversity of trading mechanisms, and recognizing that a 'one-size-fits-all' market structure does not work well for all financial instruments and under all circumstances. Adjustments will need to be considered to increase meaningful transparency in the market, but MiFID II/R transparency requirements should also be well calibrated to achieve the objective of fair and effective markets.

Whilst MiFID II seems to have fallen short of providing the expected transparency to the market, this is mainly due to the lack of accessibility of the data – the fragmentation of data across the different venues and Approved Publication Arrangements (APAs) – as well as its lack of readability, being reported in different formats.

The MiFID II Review should therefore first and foremost focus on the creation of a Consolidated Tape and focus on smaller and retail investors which will help increase their participation in EU markets. A Consolidated Tape has the potential to significantly increase transparency by providing investors with a single, cohesive view of trading across the market. Once we have a Consolidated Tape, we will then be able to better assess the transparency that we currently have in the market and will be better placed to make further and more informed changes to the regime.

The new MiFID II regime will also need to strike a delicate balance between more real-time transparency on the one side, and the liquidity costs of introducing too much transparency too quickly on the other. When looking at these issues it is important to take into consideration each asset class separately as the liquidity profiles and market activity will significantly vary from one to the other.

The CMU should promote policies that maximise the funding of the real economy.

In the bond space, for example, the Commission is proposing to significantly reduce the post-trade deferrals for corporates bonds, to a maximum of end of day for price information and a maximum of two weeks for volume information. Shortening the post-trade deferrals will result in a reduction of capital deployment to facilitate those trades. This will risk worsening market liquidity and prices for European investors, when dealing in illiquid or large in scale transactions. Associated costs will be particularly felt for instruments where risk taking intermediation is a more important part of liquidity provision. Indeed, some of these instruments are by nature less liquid (there are fewer readily available buyers and seller in the market), and therefore liquidity providers play an increased role in liquidity provision in these markets. The Commission proposal therefore does not provide sufficient flexibility to cater for the wide spectrum of bond instruments in scope of the regime and underestimates the role that risk taking liquidity provision plays in the European markets.

The Capital Markets Union (CMU) should promote policies that allow financial markets to maximise their role in funding the real economy. Behind a strong, more innovative and competitive CMU is market infrastructure, which promotes deep and liquid markets. COVID has reminded us how fragile market liquidity can be and of the importance of having efficient markets and encouraging a diversity of trading mechanisms to be able to better deal with adverse market conditions. Whilst reviewing MiFID II, policymakers should also continue to take into account the different execution venues and the role that they each play in the wider ecosystem.

A diverse market structure and the existence of competitive business models is the backbone of an integrated, resilient, and competitive European market. Rather than focusing on pushing more trading on exchanges, as seems to be the intention of the recent proposals in the equities space, MiFID II should focus on providing end-investors with choices which in turn can optimise their trade execution, fosters competition and drive transaction costs down. It also facilitates market stability by avoiding concentration of trading on just a handful of venues during venues outages.

HEATH TARBERT
Chief Legal Officer -
Citadel Securities

Strengthening EU capital markets through transparency

The Dalai Lama once observed that "a lack of transparency results in distrust and a deep sense of insecurity." What is true generally is certainly true in markets. Transparency is key to building the public trust and confidence that healthy capital markets require.

As the former Chairman of the US CFTC, I saw first-hand how vital transparency is to well-functioning markets, including by shining a light on areas where systemic risk can build. Transparency allows an honest assessment of market structure and risk, making it essential to sound regulation and fostering greater competitiveness, depth and liquidity.

I believe that the proposed enhancements to MiFID II will make EU capital markets more transparent — and thus more competitive and resilient — by establishing real-time post-trade consolidated tapes ("CTs") across asset classes and streamlining transparency deferrals. These measures are critical to the future growth and competitiveness of EU markets, consistent with the objectives of the Capital Markets Union.

Consolidated Tapes

The proposal contains several features that are critical to its success:

- The CTs will cover post-trade transaction data only, which will make them simpler to implement than pre-trade quote CTs, minimize concerns about latency, and significantly reduce any impact on exchange market data revenues.
- The CTs will be comprehensive, covering both on- and off-venue activity, ensuring a level playing field, including between exchanges and systematic internalisers ("SIs").
- Mandatory contribution, free of charge, of necessary market data will facilitate the emergence of commercially-viable yet low-cost CT offerings, while revenue sharing for equities market data will recognize the role that primary listing venues and lit secondary markets play in capital raising, price discovery and liquidity formation.
- Appropriately-tailored CTs will be established for a broad range of asset classes, including equities, ETFs, bonds and cleared OTC derivatives. Prospective CT providers are already actively developing offerings and consolidating currently available data in each of these critical segments of EU capital markets.

Real-time post-trade CTs will make EU markets more transparent, competitive and resilient.

- The collection and dissemination of market data as close to real-time will unlock the full benefits of transparency. Real-time data is critical so investors can compare quoted prices to those of recently executed trades – which is central to assessing execution quality with accuracy and demanding accountability from liquidity providers. Real-time data also minimizes information asymmetries, which increases investor confidence across all market conditions, enhances pricing and risk management capabilities, and helps dampen volatility and improve overall market resiliency. Given the volume and frequency of transactions in EU equity markets, even a 15 minute delayed tape would not yield these same benefits.

Deferrals

Streamlining post-trade transparency deferrals in the bond and cleared OTC derivatives markets is essential to leveling the playing field for investors and to creating the conditions necessary for a CT to emerge. Today, real-time pricing data is not available in these vital markets for the vast majority of transactions, and is instead typically deferred for 4 weeks. Such stale data yields no tangible benefits for investors and, left unaddressed, would leave little meaningful data for a CT to publish. The proposed enhancements will allow vital pricing data to be published in a far more timely manner, while still allowing a deferral for associated volume data.

Academic research has conclusively documented the material benefits associated with increasing transparency in historically opaque markets. The post-trade CTs implemented in the United States for bonds and OTC derivatives both have a maximum price deferral of 15 minutes. During my tenure at the helm of the CFTC, we considered whether to extend the deferral period for large OTC derivative transactions. After conducting economic analysis and receiving extensive public feedback, we concluded that a 15 minute deferral was appropriate, acknowledging that "[t]he vast majority of commenters opposed a 48-hour delay" and "expressed concerns that a 48- hour delay would have a negative impact on transparency, price discovery, and liquidity."

Conclusion

Healthy capital markets are fair and open. As a former regulator, I applaud the launch of a thoughtful post-trade CT framework for EU capital markets. CTs will strengthen EU capital markets by making them more transparent, and thus more competitive and resilient. I also believe that CTs will raise the visibility of regional venues and promote on-venue trading. The myriad long-term benefits will far outweigh the implementation costs and any short-term concerns by incumbent trading venues, intermediaries or data providers. The best interests of EU financial markets and investors at large should drive the EU to seize this historic opportunity to embrace more transparent capital markets.