MiFIR Review: key pending issues and expected impacts

1. Context and objectives of the MiFIR review

The Chair emphasised the importance of the Markets in Financial Instruments Regulation (MiFIR) review initiative, which aims to update the operating system of EU capital markets. Issues being tackled in the context of the review include the possible approach to setting up a consolidated tape (CT) and how to address payment for order flow (PFOF), as well as market structure and transparency issues raised by the current legislation. Following the publication in July 2022 of the report from the European Parliament on the MiFIR review proposal, the objective is to complete this review under the Czech EU Council Presidency.

An industry representative noted that the European Union is at a crossroads, not only with the current energy crisis and high inflation rates, but also with an increasingly constrained public financing system. Accelerating the development of capital markets in the EU is vital to support economic growth and the green and digital transitions. In respect of equity markets, the European Union is falling significantly behind other jurisdictions. In 2021, 60% of the IPOs at the global level went live in the US or Asia and only 12% in the European Union. One single US GAFA company has more market capitalisation than all of the German DAX combined. European capital markets are also probably the most fragmented in the developed world, largely as a result of the MiFID I and MiFID II / MiFIR reforms.

An official noted that significant progress has been made over the last few months in the discussion on the MiFIR review proposal, especially on the evolution of transparency regimes and market structure issues. Particular attention should be on ensuring Europe benefits from an efficient and competitive market structure in order to preserve and develop a diverse and competitive trading environment. This is all the more important after Brexit.

2. Proposals regarding payment for order flow (PFOF)

An official emphasised that strengthening capital markets is a key objective of the EU. There should be an openness to all mechanisms likely to facilitate access to capital markets for investors and retail clients in particular. One of those forms of access is building on PFOF, which makes it cheaper and easier for retail clients with very small volumes to access markets. In Germany, PFOF played a key role in boosting the participation of retail investors. A study from BaFin shows that prices at PFOF venues for small volumes are similar to or better than the reference market. In the German stock market, PFOF order flow is usually executed on regulated markets, operating in full compliance with the existing transparency requirements. In addition, a recent academic study based on trading data in Germany did not find any negative impact from PFOF practices on the quality of bid and offer prices at a reference market.

A regulator agreed with the final objective of making markets more accessible to clients and lowering fees, but stressed that the PFOF system can create detrimental conflicts of interest between the broker and its clients. The broker potentially has an incentive to direct order flow to market makers offering PFOF arrangements, rather than acting in the best interests of its clients. In addition, the added value of PFOF is not demonstrated. Studies on the benefits of PFOF are not unanimous, with some concluding that there is equal or worse execution in 80% of cases with PFOF. There are also other ways of lowering fees, such as fostering competition among execution venues and encouraging efficiency improvements at the broker level. Some new brokers that are not using PFOF have significantly decreased commissions by being more efficient and increasing reliance on IT. For these reasons a ban on PFOF is worth considering.

The official acknowledged the possible conflicts of interest created by PFOF and the importance of ensuring a level playing field. However, imposing a ban on PFOF before assessing in greater detail the impact of these new structures seems premature. A mandate should be given to ESMA to assess PFOF practices, particularly their impact on clients and in terms of facilitating access to capital markets and whether conflicts of interest could be addressed by transparency requirements.

The regulator suggested that MiFID best-execution rules, which aim to ensure that retail clients get the best conditions when they access the market, should help to tackle these issues. However, best execution rules have been transposed in different ways across the EU leading to the possibility of regulatory arbitrage. ESMA should be asked to develop common technical standards under MiFIR determining how best execution should be measured, for example how many venues must be compared, how frequent the comparisons must be and how to aggregate smaller or bigger shares, rather than simply assessing the ways to improve best execution in relation to PFOF.

The Chair summarised that the potential for regulatory arbitrage is a key factor in discussions about PFOF. One of the main roles of ESMA is ensuring a level playing field in the EU capital market.

3. Market structure issues

An industry representative explained that market structure is extremely important for the proper functioning of primary and secondary equity markets. A report published by Liquidnet in July 2022 shows that regulated markets in the EU accounted for only 28% of the market share in the first semester of 2022, compared to 27% for systematic internalisers (SIs). There has been a drop in the share of trading executed on exchanges, which are the most transparent venues, by more than 50% since the introduction of MiFID II in 2018. The proportion of lit trading is significantly higher in other leading capital market jurisdictions such as the US. A study published by the French AMF on SIs indicates that the average order size in SIs is around €37,000. Given that some of these transactions are very large, this means that a great deal of small transactions are also running through these vehicles, which were initially introduced for handling large in scale institutional orders in order to avoid market impact.

The industry speaker considered that many of the changes already proposed in the context of the MiFIR review concerning SIs are positive. The changes to the reference price waiver to avoid the matching of smaller trades at midpoint by SIs are welcome, as well as the increase of the pre-trade quotation size for publication requirements. However, the threshold should not be artificially set at Level 1 but instead defined by ESMA. If it is set at Level 1, the threshold for the pre-trade quotation size for publication requirements should be at least two times average trade size, rather than two times standard market size. Further action is needed however in some other areas. An authorisation and monitoring system should be introduced for SIs. This would allow a better monitoring of SI activity for elements such as tick size application, matched-principal trading compliance and the application of the share trading obligation for ad hoc and infrequent trading. A large in scale threshold for SIs should also be considered, although this may be difficult to achieve in the current regulatory environment.

A second industry representative had different views on how the competitiveness of EU equity markets may be improved. The focus should be on achieving the best outcome for investors and less on the market structure, which means offering investors choice, including through different trading modalities. New entrants over the last 15 years, since MiFID I was introduced, have brought some complexity and liquidity fragmentation in the market, but also innovation and better outcomes for clients. Studies conducted by the speaker's firm, a large investment bank, have shown that the competition that was introduced by MiFID with new venues entering the market, led to a reduction of 20% of implicit trading costs for institutional clients. Explicit costs of trading also decreased significantly over the same time period. This has resulted in a reduction of average trading costs, which has been passed on to end investors. In surveys, clients state that they are satisfied with the different trading modalities proposed and see improved execution quality. This competition across venues needs to be maintained and liquidity should not be forced out of venues that provide satisfactory outcomes in terms of cost, otherwise investors will trade less and that will be to the detriment of companies seeking financing and retail investors. Where there are still major differences in terms of trading costs and potential structural issues is between primary exchanges and multilateral trading facilities (MTF). On average, trading on a primary exchange costs six times more than on an MTF in Europe, excluding Austria in their experience.

A regulator suggested that, for SIs, adapting the limits, the quoting sizes and the use of the reference price waiver to the current market reality seem the right way forward, as the standard market size has slowly but steadily decreased.

A third industry representative stated that significant improvements in transparency have been provided in the bond market by regulated MTFs since the inception of MiFID II in 2018. MTFs have increased the proportion of lit execution significantly and this should be preserved. MTFs have also brought stability, operational resilience, regulatory reporting, surveillance, fairness and order to the bond markets, by virtue of having an order book in particular. However, the same problems outlined by the first speaker with regard to the development of off-exchange trading for equities are happening in the bond market. Software solutions are synthesising the experience of MTFs without being regulated, which has consequences for the trading venue perimeter defined in MiFIR. In addition, all the software solutions that are currently operating this way are third country solutions, predominantly from the UK, that are unregulated in the EU. In some cases the communication around these solutions is quite misleading, presenting them as trading venues. ESMA is aware of this threat and is seeking comments from market participants on a draft opinion piece addressing this issue. The proper definitions and criteria need to be put in place to tackle this issue.

An official outlined the approach that had been taken to transparency issues during the French EU Council Presidency. A first objective was to better encode public policy choices in quantitative analysis and produce better informed cost-benefit analyses on every aspect of the MiFIR rulebook. Precise and evidence based decisions are needed regarding thresholds and calibrations. In this respect, ESMA would benefit from clearer directions and mandates from the Level 1 text, so that it can carry out the analyses needed to better calibrate the thresholds and requirements. Secondly, it is necessary to take into account the ongoing review of the capital market regulation and transparency regime in the UK, because it is not in the market players' interest for the UK and the EU to have regulations that diverge significantly. The two approaches are not that different so far however.

A second regulator stated that even more important than ensuring a level playing field between the different venues is ensuring that the perimeter of multilateral trading is clearly defined so that the transparency regime is implemented appropriately and is not misleading. The work conducted by ESMA to define what constitutes a multilateral system is important in

this respect. The review of the share and derivatives trading obligation, to achieve a trading obligation with sufficient flexibility if a suspension is needed, is also important. ESMA should be asked to define a proper calibration of the conditions for implementing this obligation, also taking into account market conditions and the need to remain competitive.

4. Proposals for enhancing transparency

An industry representative considered that the dark trading double volume cap for equities has not functioned. The introduction of a single volume cap is relevant, but the threshold could be increased from 7% to potentially 15%, if the mechanism captures all types of trading in the market, including SIs and especially frequent batch auctions which are developing and may constitute a potential loophole in the future if they are not included.

Another industry representative indicated that in bond and derivative markets, ambitious transparency regimes with limited deferrals improve pricing, liquidity and resiliency. Some are concerned about how additional transparency could compromise liquidity provision, but the reality is the exact opposite. The benefits of transparency in bond and derivative markets have been demonstrated by academic research and market monitoring of the US capital markets for over 20 years in liquid and illiquid segments and for large and small size trades. The positive impact of short deferrals on spreads and the benefits for market participants have also been emphasized in the Econ Committee report on the MiFIR review proposal. Limited deferrals support deeper liquidity and a better quality of pricing for investors in bond markets, but also enable other indirect improvements, such as the growth of bond exchange traded funds (ETF), an increased robustness of the credit derivatives markets, a growth in portfolio trading and a greater transition to electronic trading. All those developments may further improve the liquidity and resilience of the underlying cash corporate bond markets and also provide additional tools to enhance price discovery and hedging capabilities. This type of transparency also gives dealers and liquidity providers more tools to effectively intermediate the markets. A phased-in approach to the improvement of deferrals is fine, but excessively long deferrals should be avoided. The endpoint reached in the United States capital markets with respect to deferrals is a 15-minute maximum deferral. It is fine to start with T+1, for example, but the end goal should be clear and there should be a plan to phase that in. Another industry representative agreed that short deferrals are beneficial to the market in general.

A regulator was supportive of the objective of further harmonising transparency requirements and curbing dark trading, but emphasised the need to be mindful of the trade-off between liquidity and transparency. The main point that should be addressed at Level 1 concerning transparency is the double volume cap mechanism. A single volume cap would be the right solution For the remaining issues, the solution would be to empower ESMA to e.g. consider reference price waivers and define delayed periods for price and volume deferrals.

Another regulator observed that there is a tension between the cost of trading and the quality of price formation. The MiFIR review aims to simplify and adapt the present transparency regime and also to increase harmonisation. In terms of simplification and adaptation, moving towards a simpler volume cap regime is necessary, as well as having a class of instrument approach for the post-trade transparency for bonds. Concerning harmonisation, the aim is to move as many rules as possible to MiFIR in order to reduce current national specificities is very relevant. Care must also be taken to avoid the introduction of new national specificities. For instance, it has been suggested that the transparency regime for government bonds should be defined at national level and that the level of transparency could be lower for these bonds, which are the most liquid ones. This does not seem to be an appropriate way forward because such issues should be addressed from a regulatory perspective at the EU level.

There is also a question as to how changes in legislations such as MiFIR could be handled more effectively in order for the EU to keep pace with changes in the market, the regulator stressed. The way other jurisdictions such as the US or the UK function should be considered. Indeed, legislative reviews of Level 1 texts such as MiFID II and the MiFIR review take several years. Having to go through the full legislative cycle for adapting technical standards such as certain caps and thresholds to changes in market conditions puts the EU at a disadvantage compared to other markets. An authority such as ESMA should be empowered with making such changes, without needing a full legislative review..

5. Issues remaining to be addressed concerning the Consolidated Tape proposal

Answering a question from the Chair about the priorities that should be pursued in the consolidated tape (CT) project in terms of asset class and type of data, an industry representative commented that they are agnostic as to which asset class goes first. If equities go first, bonds will follow shortly after, and vice versa. Creating the proper regulatory and economic environment for a CT to emerge and for a consolidated tape provider (CTP) to be able to operate that CT is more important. A first question is how the transparency improvements proposed in the MiFIR review in terms of e.g. deferrals, waivers, etc. will materialize and whether they will facilitate the implementation of a CT. The details of this need to be examined. In addition, operating a CT is not a technical challenge, because a CTP will do something very similar to what the Approved Publication Arrangements (APAs) do currently. It is mainly an operational and economic challenge and this explains why no CTP has emerged since 2018, when the

legal framework for operating a CT was set out in MiFID II. In the MiFIR review proposal text there was a plan B, with ESMA potentially operating a CT if no commercial CTP emerges. The direction of travel is now moving away from that option. However it is still uncertain whether the conditions will be met for a commercial CTP to emerge.

A second industry representative agreed that the implementation of the CTP project needs some fine-tuning, but it is important that it moves forward at a deliberate pace in order to avoid the EU falling further behind other global financial centres. There are indications that the UK remains committed to progressing a CT for the fixed income and equity asset classes. The US is assessing options for further enhancing the timeliness and scope of their existing CTs, with consultations on the possibility to add US Treasuries to the scope of transparency and to shorten deferrals on the non-equity side. The simplest and most logical approach for the EU would be to start with a real-time post trade CT for both equities and non-equities. That would be simpler to deliver than a pre-trade CT, with less message traffic involved. In addition there would be less latency concerns with post-trade data and the controversy over potential impact on exchange market data revenues would be removed, since those revenues largely stem from the sale of pre-trade quote data, and not post-trade execution data.

A third industry representative stated that the fact that a CT will help to improve capital markets is indisputable. The main arguments for deferring the project so far have been based on commercial factors, such as cost and complexity. A real-time post-trade CT for equities and non-equities is a reasonable compromise but should not be the ultimate aim, because a pre-trade tape would eventually be much more useful. The CT also needs to be designed in an appropriate way. Most of the major banks already have invested in systems that provide them with accurate and timely data, but they do not look at the same elements as clients, so there is an issue of reconciliation and consistency that may be addressed with the post-trade CT. A 'simple' real-time post trade CT that would be limited to recording trades that may happen at different times and cannot be compared is not particularly useful. There needs to be a timestamp with the European Best Bid and Offer (EBBO) for liquidity assessments. But if the decision is made to go that far, moving to a pre-trade CT may be a better option. A CT could help to alleviate some challenges as well, such as those related to exchange outages, which impact reference prices and cause significant financial losses for brokers.

A fourth industry representative noted that what has blocked the emergence of a CT so far is mainly the insufficient level of data quality from alternative execution venues. This is not a question of waivers or deferrals, but of accuracy and control of the market data reported to the national competent authorities (NCAs). Several exchanges had tried to set up a CT when MiFID II came into force, but the projects were abandoned mostly because of data quality issues from alternative execution venues. The reality of this problem is reflected in commercial offers that exist on the market, providing 70% to 90% market coverage. A CT with 100% coverage across the EU would provide investors with significant added value, but is dependent on major improvements in terms of data quality that ESMA needs to lead in connection with the NCAs, because previous industry-led initiatives have not been successful. The industry speaker agreed with previous speakers that a post-trade CT would be the best option to pursue. A pre-trade tape would create a two-tier market, with some of the investors provided with reference prices that would be illusionary, because they would always be delivered more slowly than those that large market players have based on low latency feeds. In addition the CT must be cheap and fast to implement, which does not seem possible for a pre-trade CT. In terms of sequencing, starting with bonds makes most sense because that market is far less transparent than equities.

An official stated that the CT remains one of the most challenging topics of the MiFIR review discussion at political level, although there is a clear need for a cutting-edge CT for equity and bond markets in particular. The benefits of a CT are multiple, including better integration of European markets and providing visibility to European and foreign players on the state of liquidity in European markets. This is all the more true for smaller markets that also need to be in the remit of the CT. A CT will also provide valuable market data that regulators and policy-makers can use for establishing regulations and market standards. The CT is not intended to be a substitute for the data services offered by stock exchanges. Stock exchanges will be remunerated by the CT and therefore will benefit from it. The US market demonstrates that a CT is likely to attract much demand and therefore generate significant revenues.

A regulator agreed that the CT project is worthwhile but stressed that the expectations should not be too high. A CT cannot solve all the transparency issues identified in the MiFIR review and cannot be a substitute for the other measures proposed. In addition, a pragmatic approach should be taken. Phasing the CT is part of this, meaning that the optimal scenario will not be reached in the first step of implementation. Data quality and data revenue issues also need to be considered. The first step should be an equity post-trade CT, before moving into non-equity, starting with bonds and then derivatives, and potentially ETFs could follow. A pre-trade CT can be introduced once sufficient experience has been gained with the implementation of the post-trade CT.