SESSION SUMMARY - HELSINKI SEPTEMBER 2019

MiFID II state of play and remaining challenges

1. Transparency and market structure improvements and pending issues

1.1. Equity markets

A regulator noted that transparency is a means to improve investor protection and financial stability. The crisis demonstrated that without transparency there will be higher risk premiums, higher volatility, and eventually capital markets that do not function so well. However achieving a level of maximum transparency is not needed in all markets. What is needed is a level of transparency adapted to the market concerned. Looking at the equity market, there has been a change in the market structure with MiFID II with fewer dark pools and less OTC trading but there has not been an increase in the truly lit market, due to the increase of systematic internalisers (SIs) and auctions. All in all, equity markets are not in a substantially better position.

Another regulator stated that significant improvement has been seen on transparency since MiFID II came into place, particularly on the equity side. Transparency has improved, as well as the ability of national competent authorities (NCAs) to monitor some of the markets. Improvements have also been observed in the exchange-traded fund (ETF) space. In addition, efforts have been made in specific areas such as pre-trade transparency waivers. Around 1,000 different waivers have been looked at to ensure a fair and level playing field between trading venues. A first report will be published on this by ESMA in October. However, there is still much work remaining to be done on transparency.

An industry representative observed that there are 660-plus trading venues registered across the EU. Some may call this 'competitive', but it could also be called 'fragmented'. On the equities front, the evidence shows transfers between the OTC and the systematic internaliser (SI) segments with an explosion of SIs - around 212 SIs are registered now - but the share of regulated markets in the lit venues has slightly decreased after the MiFID II introduction. 10 years after the G20 Pittsburgh commitments, the EU is not coming out that well on transparency, despite progress in risk management and reporting. Some safeguards, such as the double-volume cap do not seem to function. The proxies such as the number of IPOs and market capitalisation do not show significant progress either. It is therefore questionable whether the current market structure is in line with the political objectives set for MiFID. More work is needed to avoid further erosion of the equity ecosystem. Another factor is that the intra-EU competition introduced with MiFID has significantly reduced the transaction fees of exchanges, but the total execution costs for end-investors have not actually decreased, which remains to be tackled.

A regulator noted that improving transparency in the market is challenging because 'lighting up' some parts of the market leads certain trades to move to other parts. This raises questions regarding the appropriate market structure to favour. Transparency may not have improved significantly as a result of the transfers from OTC towards SIs and auctions.

Another industry representative thought that MiFID II has had many positive outcomes. Post-trade transparency has improved, the algo control framework is a step forward and best execution has progressed, although there is still room for improvement. There are, however, other areas which are less positive and where implementation has not been satisfactory. MiFID I allowed a dramatic reduction of explicit costs to the benefit of investors through a decrease in commission rates. Implicit costs also went down over time, in terms of spreads narrowing and more liquidity coming into the marketplace, which also benefits end-investors. Competition and choice deliver best execution to end investors and, in the speaker's view, the legislator's focus should be on investor outcomes. The concern with MiFID II is that some of the objectives have been interpreted in such a way that increases costs for investors, e.g. with a strong focus on shifting liquidity to lit markets such as domestic exchanges, which is not the right metric to consider. The correct metric are investor outcomes, especially given the objectives of the CMU. The marketplace needs to support many different types of investors with different objectives and different order sizes. The ability to do this is what needs to be looked at and different modalities of trading are key. The clients of the speaker's firm are generally institutional, such as pension funds, but they usually invest on behalf of thousands of individual retail investors. These orders are very large and these clients do not want to go to the lit markets, because as soon as they do so, the information on their transaction will be public, and they may get a worse outcome, to the detriment of the individual investors on behalf of whom they are acting. The preferred route with MiFID II should be to analyse the outcome for end-investors as opposed to simply looking at lit market liquidity, the speaker suggested. Innovations in the market such as periodic auctions are worth considering in this perspective for instance, because they have been designed in such a way that protects the best execution for clients. Such methods of trading should be allowed to continue.

A regulator agreed with the previous speaker that there has not been that much progress in the equity markets, because it is being looked at the wrong way. Many costly measures have been put in place, such as the double volume cap operating now on hundreds of shares, but this is not delivering better outcomes for investors. Going forward, there should be more focus on investor outcomes rather than just on transparency criteria.

Another industry representative was concerned that the way regulated markets currently operate might put off some retail investors. Their organisation has seen a decrease of 13% of the orders executed through the stock exchange compared to last year. Part of the explanation is that orders are increasingly executed at closing time. On the Euronext market for example, 49% of the daily turnover is processed at the closing. This means that price discovery is less efficient and transparency benefits are becoming questionable. The reason for this is that an increasing number of large players on the market are seeking cost efficient ways to transact and the volume-driven policies of the exchange lead them to concentrate orders at certain times of the day. As a result, retail clients may progressively abandon this type of market, making it even less efficient. If the trend is to go back to a kind of order fixing for blue chips, this will clearly not be a positive outcome for investors.

1.2. Non-equity markets (bonds, derivatives, commodities)

A regulator considered that the bond and derivatives area is still problematic. Bond market transparency has not yet been achieved. However, it was also predicted that the transparency measures of MiFID II would have negative effects on the EU bond markets, which has not materialised and is a positive outcome.

Another regulator, taking the example of the Swedish corporate bond market noted that, on the non-equity side, there has been some progress but transparency is still very patchy, with many deferrals and waivers. There is post-trade information on various Swedish bonds, ranging from liquid government bonds to illiquid corporate bonds, that is provided two days to four weeks after the trade, in eight or nine different venues. There have been some improvements in the corporate bond market, which has moved from being a completely OTC dark market to more electronic trading on SIs and multilateral trading facilities (MTFs), which is very positive for efficiency and price formation. However, the transparency in the post-trade of government bonds has actually worsened. Some initiatives to harmonise could have been taken at the national level. However, there was enormous pressure from the marketplace to stay aligned with neighbouring countries in order to avoid bond trade flows moving to these countries.

Having MiFID II is positive however and should support progress over time with some improvements of the legislation. There is a need to regulate transparency in bond markets, the regulator stated, because if it is only done in equity markets, market-makers and other centrally placed intermediaries will definitely drive bond markets into darkness. There is now much more data, and data quality is improving, which will increase the possibility to follow the market, identify patterns, and improve the way the market works. The right balance of transparency is needed however, as full transparency is not always effective. That will, in the end, depend on the market structure and the markets. An industry representative agreed that maximum transparency is not always optimal for the market. The right level needs to be found.

Another regulator was very supportive of the increase in transparency that has happened thanks to MiFID II in the bond and in the commodities markets, which were very opaque markets previously. The problem however is that there is a great number of different products in the market and it is difficult to apply the same liquidity and transparency rules to all of them. Fine-tuning the framework starting with the most liquid and electronic markets would have been preferable, before expanding it to other products. Transparency rules seem insufficient in part because they do not target the right areas. As for derivatives, the G20 agreement on derivatives trading was implemented smoothly and went well, including tricky issues around equivalence.

On bond markets, a regulator stated that the implementation discussions around MiFID II helped to clarify that the objective was not maximum transparency. Instead, it was agreed that there should be a phasing-in process depending on the actual liquidity of instruments and other factors. In the end, this has led to very minimal bond market transparency in many aspects and much work remains to be done, which also requires focusing on the right market segments.

2. Data provision and reporting improvements and pending issues

2.1. Usefulness of MiFID II data

A regulator noted that at present 30 million transactions are processed per day, which is a significant increase compared to MiFID I. The data collected allows them to spot problems and deal with anomalies, which has helped a great deal the improvement of market cleanliness. This reporting also helps to obtain a better view of what is happening across markets. Problems such as simultaneous trading on multiple markets are much easier to detect now. The data sharing that has happened among European regulators post-MiFID II has been another improvement and greatly supports the achievement of clean markets in Europe. Another regulator stressed that all the data provided is used by supervisors and agreed that the sharing of it is an extremely useful outcome of MiFID II. A third regulator noted that much work has been done by ESMA in cooperation with the NCAs on trying to improve data completeness and quality, but it is a difficult task for which more time will be needed, because of the magnitude of the change that the method has brought.

An industry representative mentioned issues regarding the disclosure of costs and charges in relation to execution services for wholesale investors due to different interpretations of their definition. The feedback received from clients shows that this type of disclosure is not that helpful and having an obligation around this does not seem necessary. The speaker suggested that the process could be simplified by allowing investors to opt out from receiving this information, if they wish to. The speaker also underlined the duplication of reporting obligations that exists between MiFID II and the European Market Infrastructure Regulation (EMIR). Addressing this issue would be a quick fix, as would the new quality of execution reporting (RTS 27). Over 1,000 data points are produced, and clients do not consider it to be very helpful and therefore do not want to receive it.

2.2. Cost and availability of market data

A regulator explained that ESMA has started looking at some of the impacts of MiFID II rules. A consultation was conducted on the cost and consolidation of data, which are quite controversial topics, but for which greater convergence and commonality are needed across European markets. According to the input received, there is clearly an issue about the cost of market data, however there is no consensus about the causes of this and therefore how to solve it. While certain concepts can be clarified or further guidance can be provided by ESMA about how data should be provided e.g. in terms of timing or costs, there are limits to how far these improvements can go. What is key is to properly implement the requirements in a consistent way throughout the EU, particularly those around data completeness and data quality in the OTC derivatives and bond spaces, which requires convergence in supervision and enforcement.

An industry representative stressed that data providers are increasing their fees by a huge percentage. There is a real issue of profitability, and it should not be forgotten that this is data coming from investors' trades. Therefore investors are being asked to pay a great deal for data that they themselves helped to create. In addition, without brokers, there would be no data. The speaker also noted that data firms are not regulated, and the reason for this is unclear.

Another industry representative agreed that data costs are a problem. The cost of market data has been going up significantly, and it is not a new issue. The recognition of the problem and ESMA's assessments in this area are a step forward however. The industry has proposed moving towards what is called the 'transparency plus' model, where data providers would have to disclose the costs of producing the data.

A third industry representative noted that the Federation of European Stock Exchanges has published statistics on the revenues from data. Exchanges across the EU are making a total of about €245 million revenues from market data, which is a fairly small amount compared to the revenues generated e.g. by crypto-assets which have not attracted so much regulatory interest. The prices of level 1 and level 2 data have increased over the recent years by 1.5%. Moreover, exchanges only represent 15% of the total costs of market data, which means that regulators should be looking at the whole value chain if savings are to be made for end-investors.

3. Issues to be considered in the further stages of MiFID II

Macro-economic context: An industry representative described the challenging economic backdrop against which MiFID II needs to be considered. There is an urgent need for the EU to progress on many fronts, notably on capital markets, for which MiFID II is instrumental. The speaker noted that the overall growth of the world economy is cooling down, but Europe is lagging behind the other regions with a growth at +0.9%, compared to +6.4% for Asia and +2.4% for the US. Resilience in the EU is also lower than in other leading jurisdictions. On monetary policy the US Fed has significantly more leeway compared to the European Central Bank (ECB). EU banks are healthy, but only 2 of the top 30 banks globally are on the continent. Europe is also lagging behind on many key market indicators such as the number of listed companies, IPOs, market capitalisation and retail participation levels. Finally further integration is needed on the Economic and Monetary Union (EMU) front, as well as a finalisation of the banking union and CMU.

Brexit implications: A regulator noted that the UK leaving the EU would impact MiFID II significantly. There is a great deal of activity covered by MiFID II happening in the UK today, and this will continue post-Brexit. The UK has onshored an identical version of MiFID II, which will come into effect if there is a hard Brexit. There will be perfectly mirroring rules, which provide consistency and certainty for firms and minimise work for the UK-based industry. The speaker identified three areas where there may be potential duplications post-Brexit between EU and UK requirements and that need to be addressed. Another regulator noted that the UK is far more than 50% of the capital markets in Europe. The idea of the Brexiteers is not to have exactly the same legislation, so the UK might change its version of MiFID II later, which also needs taking into account.

The first area where post-Brexit overlaps may happen is the share trading obligation (STO) and derivative trading obligation (DTO). The regulator noted that overlapping STOs and DTOs between the EU and UK are just not going to work and this is not good for the EU and UK markets. This issue needs to be rethought. The focus should be on best execution for the investor rather than STO, the speaker believed, and now that there is much more data available on best execution, a framework should be developed around that. On the STO, the FCA has not set out its approach yet, as it was not necessary to do so until it was clear that the UK was leaving on a particular date. This will be kept under review, and the FCA is listening to market participants. Work has been done by ESMA and the NCAs to limit the scope of potential overlap by removing UK shares from the trading obligation, for example. There are some remaining issues with e.g. sterling versions of EU shares that are mainly traded in the UK. In addition the way that the new approach has been designed to focus on International Securities Identification Numbers (ISINs) would also catch any new listings, absent any further guidance. Another regulator emphasised that from an EU27 perspective the aim is to avoid overlapping and conflicting requirements in a Brexit context. The EU is now waiting to see how this issue is going to be addressed by the UK. The second area is transparency calculations. A regulator noted that MiFID II has a relatively mechanistic way of determining whether something is transparent or not, and at what level. There cannot be two systems in the UK and the EU that deliver different transparency thresholds post-Brexit, otherwise there is a risk of regulatory arbitrage in the decisions that will be made about where to trade. The third area is trade reporting. A regulator noted that in a hard Brexit, firms will need to report both to the FCA and to their home regulators and that data will not be able to be shared. This will lead to extra-costs, which may undermine the ability to oversee markets if no common solution is found.

4. Proposed way forward for improving MiFID II

4.1. Overall objectives and approach for improving MiFID II

A regulator suggested that legislative solutions for tackling the problems raised by MiFID II should not be jumped to until the legislation is fully implemented and enforced and a detailed review has been conducted.

An industry representative cautioned against setting too big an ambition for the review of MiFID II, which should not take 10 years to deliver like the initial implementation. MiFID has been extremely costly to implement, and still continues to be so for financial firms and also for their clients, because it impacts a broad range of activities (brokerage, securities trading, asset management…). Progress can be achieved with adjustments to calibrations and the implementation of quick fixes through Level 2 measures, without having to review the whole legislation. In parallel, or in sequence, there should be a broader review taking into account the implications of Brexit and its expected impacts on the European market structure.

A short-term action plan should be prepared, the industry speaker proposed, for tackling some issues with MiFID II on which there is a wide consensus, particularly with Brexit looming. This includes having a single deferral regime for large bond and derivative trades. This may not be considered as a major improvement but for investors such as pension funds performing large trades it would be a major improvement. A second issue to put on that list would be the STO and the tension with best execution. There are some cases where, if the requirement of the STO is met, the trading does not happen where there is most liquidity. Clarifying that the best execution obligation should take precedence over the STO could be a way of dealing with that tension, if there is a desire not to review the STO.

A regulator felt that a step-by-step approach, taking the low-hanging fruit first, should be adopted for tackling the issues previously mentioned, while preserving the positive outcomes of the legislation. But first the precise goals of MiFID II need to be more clearly defined. Is MiFID II mainly aiming to develop capital markets or increase transparency? Is growth the priority or financial stability? This needs to be clarified first, as it will increase the credibility of MiFID II.

Another regulator emphasized that the review of MiFID II should be performed on an evidence-base, which is possible 18 months after implementation. Many of the changes suggested are a 'refit' of MiFID and should not require going through a whole new legislative process. Adjusting calibrations or implementation measures should be possible, however in some cases it would require ESMA being equipped with stronger powers or tools than what has been adopted in the ESAs review.

An industry representative felt that the starting point should be a revisiting of the political objective of MiFID II in terms of transparency, based on an observation of the outcome so far. There is a collective responsibility in ensuring that capital markets in Europe have a regulatory framework that allows them to contribute to economic growth and to achieving the CMU, while ensuring sufficient financial stability.

Another industry representative believed that the main focus of MiFID II should be on removing barriers to competition wherever possible, and providing better outcomes to clients. Whenever there is a monopoly or lack of choice, there may be a deterioration in investor outcomes. It is seen in market data or with closing auction fees, for example, which are generally more expensive than continuous trading. The most important short-term goal in that perspective is to figure out the STO, due to a serious impact on best execution for clients. Using currency in combination with ISIN could also reduce the overlap issues between the EU and UK with STOs. Another priority is to progress the agenda on the consolidated tape, as it will give better outcomes to clients.

4.2. Proposals for improving market structure and transparency

An industry representative felt that what needs to be achieved is a true regulatory level playing field between execution venues and trading platforms. MiFID has been important in reducing transaction fees on exchanges, but the key question is why these savings are not coming out for the end investor and where they are lost in the intermediary chain.

A regulator noted that there is no right level of transparency for markets, except that 0 or 100% are wrong. More of a philosophy also needs to be developed around what it is that makes markets work well, alongside transparency and to consider that when calibrating the regime. This would also help to develop a more venue agnostic approach, focused on market or investor outcomes rather than on the type of venue through which orders should be executed. If this can be achieved, it would help to solve the current problems with the STO and transparency.

An industry representative noted that market structure discussion is essential because it relates to the price formation process. A recent study shows that wherever the primary market remains closed, the alternative execution venues that use reference data provided by the primary market do not even open. Since these different venues trade the same instruments, they should be subject to similar requirements, or varying requirements in light of the savings that can be achieved for end investors. The issue is that with MiFID I and II, only about 40 to 50% of overall trading volumes in Europe are price-forming, whilst there are 65% in the US and well beyond 80% in Japan.

The industry speaker mentioned other areas of transparency requirements that would need adjusting particularly for commodities. The pre-trade transparency regime needs to be reworked; there is not a single exchange across the EU so far, after 18 months, that is compliant. On the permission limits regime, the EU needs a much more differentiated approach going forward in light of, for example, other important initiatives on the radar in relation to the international role of the euro, because for a market maker, it is impossible to build up a euro denominated liquidity pool in the present set up. Again, the double volume cap had a clear intention behind it, which was a very good one, but it should be made sure that it works in this way.

4.3. Benefits and challenges of implementing a consolidated tape

An industry representative felt that a consolidated tape would help to improve transparency, which is necessary for attracting more retail investors. This requires an understanding of what is going on in the market and who is doing what, which does not exist at present. Regarding SMEs more specifically, research is also essential.

A regulator noted that there is a great deal of support for the idea of a consolidated tape, but there is no consensus on what it should contain (pre-trade, post-trade information), how it should work in practice (real-time or a record of trades at the end of the day) or how it should be put together and implemented. There are also a number of preconditions for putting it in place, such as data and time standardisation and making sure that all the trades can be captured. These are difficult questions that still need to be answered.

An industry representative noted that so far no viable commercial solution has emerged for the consolidated tape after 18 months of implementation of MiFID II. The key problem is around the data quality in the OTC and SI sphere, where the clean-up of the data disaggregation and so forth is so expensive that no viable solution is possible. Improving transparency in that area is the priority, because a quasi-consolidated tape for exchange data already exists.

Another industry representative noted that a consolidated tape would allow having visibility of the market with the different trading modalities offered, which should get people more comfortable with the idea of innovation and competition. Bringing it together and showing what the market looks like would be beneficial. ■