Enhancing transparency in securities markets

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Less complexity, more transparency

Market transparency is a central pillar of the MiFID II framework and its effective application is critical for the development of competitive markets, ensuring informed investor decisions and allowing efficient allocation of assets. After two years of application of MiFIR, ESMA is assessing how transparency in EU markets has evolved and whether the new provisions have delivered on their objectives. In line with the review mandates embedded in MiFIR, ESMA published two Consultation Papers with analysis of the transparency regime applicable to equity and non-equity financial instruments and proposals for potential adjustments of the regime.

One important achievement of MiFIR is that national competent authorities and ESMA have more data at their disposal to check on market developments and assess how the law is working in practice. ESMA has made extensive use of such data in its consultation papers and the policy proposals entailed are based on in-depth data analyses.

Those analyses indicate that significant margin for improvement remains in many areas. For instance, on the equity side the majority of trading is not subject to pre-trade transparency (between 50 to 70% of trading in turnover), including on-venue trading where a large proportion of orders benefits from a pre-trade waiver (30% of turnover for shares and 50% for ETFs).

Regarding non-equity instruments, the level of both pre- and post-trade transparency appears to remain limited. This low level of transparency is partly due to the market structures prevalent in many non-equity markets but, in ESMA's view, also due to the way the MiFIR transparency provisions are designed. On the pre-trade side, MiFIR offers a broad range of waivers which, allow to be exempted from the transparency obligations under many circumstances resulting in real-time transparency being the exception rather than the norm. On the post-trade side, a complex deferral regime that is subject to national discretion has led to a patchwork of different rules applying in the Union.

Against this backdrop, ESMA is consulting on proposals reducing the complexity of the regime. As some examples, on the equity side, ESMA is considering to turn the double volume cap into a single cap, to simplify the applicable liquidity tests and to reduce the number of waivers.

For non-equity instruments, the main proposals include reducing the number of waivers and deferrals and establishing a streamlined deferral regime without national discretion.

Following the consultations, ESMA will analyse the feedback received with a view to aim at sending its final recommendations to the Commission in Q3 2020. ●

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Taking the long view in the equity market transparency debate

Now could be a good time to take a step back and asses if the transparency rules in the EU equity market would benefit from a larger overhaul, not just one that is Brexit related. Technology is distorting the application of MIFID/MIFIR rules, and data challenges in post-trade transparency will only get more demanding. Two years is not enough to assess if MiFID has led us in the right direction or not, but in the Brexit context, there is no question that a focused review is needed. Many of the requirements and thresholds in the current framework were calibrated to accommodate UK data. Consequently, rules like the double volume cap (DVC) cannot remain unaffected by the UK's departure.

The extraterritorial scope of the trading obligation carries its own pitfalls, with the potential to fragment liquidity and drain it away from EU venues. It is also difficult to assess how the systematic internaliser (SIs) regime will look like without the UK. It is a very fraught time to be a legislator, or ▶

an interpreter of rules, such as ESMA. So far, ESMA has concentrated on fixing the perceived failure of MiFID II to reduce trading on "dark" venues; through the use of waivers, the DVC, SIs, as well as on issues such as the trading obligation, and the (lack of) consolidated tape (CT). This is the technical side of the equity market transparency debate. And that is important – it truly is. However, we also need to look ahead, to the market as we want it to be, twenty years from now. Brexit is taking away what was a significant and integral part of the EU equity market for decades, but, at the same time, it is an opportunity for us to redefine what remains.

The real review of MiFID II should focus on the long view – how do we structure our equity markets to bring the most benefit to the real economy? How do we want our retail investors to predominantly access that equity market? Do we want to incentivise direct access, access through a financial product like an investment fund, or do we want to push a balance of both. This choice has an impact on the optimal structure of the transparency rules. We are currently trying to occupy the middle ground, which implies trade-offs in between types of access, as the optimal structure will at times conflict, favouring one type and penalising the other. Funds will benefit from a different set of rules than individual retail or even other institutional investors.

Waivers, thresholds, frequent batch auctions, SIs – they all have their benefits and drawbacks. Instead of focusing on the details, we should first ask how a rule or exemption incentivises our preferred policy choice. If a waiver or a venue of execution is justified in that context, then it should be permissible. The MiFID II framework also banked on being able to centralise all the data provided by Approved publication arrangements (APAs), but there is currently no CT in sight and one may be unlikely to emerge without some form of public sector backing. However, the viability of a CT may depend on legally obligating APAs to provide free data to the CT, or for a symbolic nominal fee. If so, a privately owned CT could be problematic, and a public infrastructure CT has its own challenges.

There is no doubt that we need to fix what Brexit broke, but we also need to acknowledge that some issues have not yet matured enough for long term policy decisions. ●

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Achieving post-trade transparency in the EU non-equity markets

MiFID II laudably aimed to shine light on the historically opaque non-equity markets, including for both bonds and OTC derivatives. Regrettably, the post-trade transparency framework is not working as intended and has yet to deliver concrete benefits for investors. As the EU proceeds with the MiFID II review, addressing implementation shortcomings and establishing post-trade consolidated tapes for non-equities are necessary course corrections that will materially benefit EU investors, capital markets, and the broader economy.

Benefits of Post-Trade Transparency

Post-trade transparency, in the form of real-time public reporting of transaction prices and sizes, yields significant benefits. Myriad academic studies demonstrate that increased post-trade transparency in non-equity markets narrows bid-ask spreads and enhances liquidity. First, real-time public reporting empowers investors to accurately assess execution quality, demand accountability from liquidity providers, and obtain best execution. Second, real-time public reporting removes information asymmetries and allows all liquidity providers to better manage risk, and in turn, more confidently quote prices, commit capital, and warehouse risk across all market conditions. Third, real-time public reporting makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels.

Addressing Implementation Shortcomings in the MiFID II Post-Trade Transparency Regime

Unfortunately, to date, the accessibility and timeliness of the scarce EU non-equity post-trade transparency data that does exist is poor. First, very few off-venue transactions are subject to post-trade transparency requirements. For example, only approximately 5% of off-venue trading activity in OTC derivatives is currently subject to post-trade transparency requirements. Second, across bonds and OTC derivatives, even for on-venue transactions, four-week deferrals from public reporting are the norm, not the exception, primarily due to inaccurate liquidity assessments or excessively low size thresholds for trade deferrals. Finally, trading venues and APAs are not publishing post-trade transparency data free of charge after 15 minutes, as is required. Each of these shortcomings can be remedied and doing so will help set the MiFID II transparency regime back on course.

Establishing EU Post-Trade Consolidated Tapes for Non-Equities

In parallel with addressing the above issues, establishing real-time post-trade consolidated tapes for non-equities will ensure that EU investors can efficiently access and benefit from transparency data. The US post-trade consolidated tapes in each of the corporate bond, municipal bond, mortgage-backed securities, and OTC derivatives markets provide empirical evidence of both the value and viability of implementing post-trade consolidated tapes for non-equities. These consolidated tapes are each comprehensive, require mandatory contribution, disseminate information immediately upon receipt (both freely to the public via websites and via real-time data feeds at a reasonable cost), and feature targeted and limited deferral regimes for larger size block trades.

Conclusion

The MiFID II review process provides a critical opportunity to remedy identified implementation shortcomings and to establish post-trade consolidated tapes that together will put the MiFID II post-trade transparency regime for non-equities back on track, strengthening EU financial markets and improving conditions for investors. ●