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A robust market infrastructure for a successful CMU

Since the financial crisis of 2008/2009, Europe's financial markets infrastructure has become more robust and resilient. The excessive market volatility induced by Covid-19 is prove of that. The spike in volatility, trading volume and uncertainty has not led to substantial financial stability problems. On the contrary, EU financial markets have coped well and it is fair to say that the EU's market infrastructure has successfully passed a major stress test.

However, while robustness and resilience are important features of our market infrastructure, they are not all that matters. After all, the key feature of efficient markets from the perspective of most market participants is a price discovery process that is accurate and enables meaningful capital allocation. A prerequisite for an efficient price discovery process is market transparency.

The recast of the markets in financial instruments directive (MiFID II) was meant to specifically address this issue by "turning on the light, without turning off the tap", i.e. improving market transparency without hampering market liquidity. The recast resulted in a substantial revamp of the EU's market structure and improved transparency rules combined with a set of waivers to address certain exceptional circumstances.

About two and a half years after the entry into force of MiFID II, we can draw the first firm conclusions about the effects of the MiFID review. While the overall market infrastructure has become more robust, the results in terms of transparency are mixed. Unfortunately, we have seen that regulated markets, which come with the strictest transparency requirements and the greatest contribution to price discovery, have seen their share of trading decrease.

Instead, systematic internalisers and other less transparent trading venues have gained ground, often because the operators of those trading venues have proven to be quite apt at identifying loopholes to circumvent the rules.

While some of the loopholes might have been in line with the letter of the law, they were certainly not in line with its spirit. This leads to the inevitable question of how to address the still existing problems in the framework of the upcoming MiFID II review and beyond. Arguably, the guiding principle should be that strong in order to facilitate price discovery trading should take place as transparently as possible strong.

That means that the default trading venue for most trades should be regulated markets and not systematic internalisers or dark pools. Such a notion also implies to limit the waiver regime to what is necessary. A reduction of the overall options in terms of waivers as well as revisiting the double volume cap in principle would be logical steps.

Changes to the market structure and transparency rules will only have a very limited effect though as long as enforcement of the rules is not stepped up in a meaningful way. Many of the circumvention attempts that happen in a regulatory "grey zone" could have been prevented with more robust interventions by supervisory authorities. Most of the blame has to be attributed to national competent authorities who have often been too lenient when applying the rules, but ESMA has also failed in its coordination function to apply a stricter approach across the Union.

Lastly, a consolidated tape is high up on the wish list of many sell-side market participants. The original approach envisioned in MiFID II has not delivered the desired solution, which points at certain complexities in the process of designing a consolidated tape. It is therefore probably best to moderate our ambition and look at what is feasible. A real-time consolidated tape with the widest possible scope is probably not the right starting point for any discussion. An end-of-day record of transactions for a first subset of liquid and transparent financial instruments is probably a more realistic goal.

One thing is clear though: a consolidated tape, no matter its scope, will only work under one condition: consistent and high data quality across all venues. The data obtained must give the full picture, i.e. include all trading venues, and be of high quality as a consolidated tape or tape of record that one cannot trust is essentially worthless. Bumping up data quality to a sufficiently high degree across all venues is therefore an absolute necessity. ●