

Improving EU securities market transparency and infrastructure: priorities for CMU

1. Improvement of EU securities market transparency

1.1 Benefits of pre and post-trade transparency

An industry representative considered that ensuring a fair and efficient functioning of markets is critical for further developing the real economy and ensuring that investors, savers and pensioners are getting appropriate returns from their investments. According to empirical evidence and academic research, increasing post-trade transparency, particularly in non-equity markets, narrows bid-ask spreads and enhances liquidity. It empowers investors to measure execution quality, which allows them to demand accountability from liquidity providers and to obtain best execution. It also removes information asymmetries in the market, which allows all liquidity providers to better manage risk, more confidently quote prices and commit capital and warehouse risk in the markets. Transparency moreover makes markets more resilient, particularly in times of stress. Taken together these benefits lower the cost of capital, which increases the efficiency in the allocation of capital for both the public and private sectors.

A regulator stated that pre and post-trade transparency is an important requirement for effective price discovery and ensuring fair markets and fair competition and is thus a key element for well-functioning markets. However transparency and disclosure alone are not sufficient. The behaviour of investors also requires consideration for instance. In addition other objectives of MiFID that are important are still to be realised, including a reduction of the proportion of over-the-counter (OTC) transactions and moving towards more transactions on lit markets, while striving for less fragmentation.

A market observer noted that the Capital Markets Union High Level Forum (CMU HLF) which proposed in June 2020 measures for relaunching the CMU recognised the importance of transparency but did not consider it to be a “game-changer” for further developing EU capital markets. In addition to transaction data there is another aspect of transparency that needs considering, which relates to company financial and ESG data. At present this data is not harmonised and it is fragmented across Europe. This is why the HLF has put forward the idea of implementing a single access point in order to facilitate access to this information, particularly for international investors. It is hoped that the Commission will take that forward in its upcoming CMU proposals.

1.2 Main issues remaining to be tackled

1.2.1 Equity markets

A regulator confirmed that for the equity market the topic of transparency remains a major concern. There is a complex waiver structure at present. There are also continuous discussions on how the thresholds for large-in-scale waivers may be enhanced and how the double volume cap,

which is over-engineered and not meeting its purpose may be simplified. Fragmentation has increased in the equity market, despite the objectives put forward in MiFID II. This is due mainly to the increasing competition of systematic internalisers, issues with post-trade data quality and the lack of a consolidated tape.

A market observer noted that it was originally thought that so-called dark pool venues would be used for handling large block trades, with delayed reporting, etc. That has changed, and it is uncertain whether this change is positive for the market.

1.2.2 Non-equity markets

An industry representative stated that concerning the post-trade transparency of non-equity markets, the main issue is the real-time public reporting to investors of transaction prices and sizes. MiFID II fully recognised the importance of this real-time public reporting and laudably aimed to improve it, but that remains an unfinished task. Today only about 5% of off-venue trading in OTC derivatives are subject to post-trade transparency requirements. In addition, even for on-venue transactions, four-week deferrals from public reporting are the norm across bond and OTC derivative markets.

A regulator emphasized that the large-in-scale and size-specific-to-the-instrument waivers are also subject to enhancements. Another issue is that the non-equity market is far less-advanced than equity markets in terms of market structure and often lacks common market platforms. Although some new entrants facilitate electronic trading on multilateral platforms, request-for-quote systems and voice-trading systems are still common in non-equity markets.

Another industry representative added that non-equity markets are also less familiar than equity ones to many policymakers and regulators in charge of determining the appropriate method for improving transparency. Some of the current challenges in MiFID II may relate to an imprecise understanding of how non-equity markets operate.

1.3 Proposed improvements of the regulatory framework

1.3.1 Ongoing review of MiFID II: objectives and timeline

A regulator indicated that MiFID II introduced many improvements concerning the functioning of the markets and the further strengthening of investor protection. However, an ESMA report on the impact of MiFID II's transparency requirements on equity markets concluded that, ‘MiFID II can be considered unfinished business.’ An additional report on non-equity markets is expected to be released by ESMA in September 2020.

A policy-maker explained that the Commission has been in a ‘listening mode’ on MiFID II so far. The full MiFID II review will come no earlier than the third quarter of 2021, once all the input needed has been collected and considered,

including ESMA's report on the transparency of non-equity markets and contributions to the public consultation on these proposals. One element that needs to be considered is that there are very different views on how to improve the transparency of European capital markets. The impacts of Brexit and changes to the market structure when it comes to the biggest pools of liquidity must also be considered. The pandemic has also pushed delivery of the MiFID II review into two separate stages. One is the Capital Markets Recovery Package, which was tabled in July and aims to help businesses to access capital markets with targeted adjustments to prospectus, MiFID II and securitisation rules. The rest of the review will come in a year's time. MiFID I and II have improved the situation of capital markets, but more needs to be done notably regarding transparency. The Commission's ambition in this area is to identify the best possible approach in a holistic manner, both in terms of pre and post-trade transparency for equities and non-equities, taking into account the differences in the market structures.

1.3.2 Non-equity transparency: specificities and improvements proposed

An industry representative explained that a number of steps have been proposed by ESMA to address the scarcity, quality, timeliness and accessibility of post-trade transparency data. ESMA has recognised that very few off-venue transactions are subject to post-trade transparency so it has outlined a number of options to make the post-trade transparency framework more comprehensive and to ensure a level playing field between on and off-venue transactions. Secondly, both the Commission and ESMA have recognised that inconsistent and excessive deferrals undermine post-trade transparency. Rationalising the deferral regime offers great promise. In the US markets for example, for corporate bonds, mortgage-backed securities and OTC derivatives, post-trade transparency regimes were put in place with deferrals that do not exceed 15 minutes, even for large transactions and illiquid instruments.

A regulator agreed that the measures proposed by ESMA may alleviate the observed problems with MiFID II transparency requirements. However, these quick fixes are not enough to solve all of the issues. Differences between equity and non-equity markets need to be more carefully considered in particular. The lack of liquidity is a given in the current fixed income markets. Many instruments are tailor-made, OTC and not designed with the intention of being traded on secondary markets. This means that simply replicating the transparency requirements in place for equity markets is counterproductive. Improving the functioning of non-equity markets with more liquidity and higher and sustainable levels of transparency can only be achieved by addressing market fundamentals e.g. incentivising the standardisation of instruments, improving the trading structure and the level playing field between bilateral and more transparent multilateral forms of trading, creating more regulatory certainty. This also requires a cultural change. Regulation can support these changes, but other evolutions are needed.

An industry representative considered that the quick fixes proposed by ESMA will add value, but beyond this a more strategic end-objective needs to be defined and implemented for the market. One of the key differences between equity and fixed income is the method of execution. In fixed income, execution is a three-phase process including the identification of liquidity, price formation and execution and each phase is equally important. Whereas in equity

transactions the identification of liquidity and price formation steps are less relevant, because they are correlated to the omnipresence of that information by virtue of the use of central-limit order books. This is why the request-for-quote protocol is so important for fixed income markets, because it facilitates the identification of liquidity and the price formation element, as well as the act of execution. Robust fixed income post-trade transparency data is of most benefit in the identification of liquidity and price formation, hence the recommendation to focus on post-trade.

A market observer agreed that there should be careful consideration of market structure and of the differences between equity and non-equity markets. Whatever approach is taken, there has to be clarity about the economic benefits and incentives provided for the market.

1.3.3 Consolidated tape implementation challenges

A policy-maker mentioned that the implementation of a European consolidated tape, which would solve many aspects of the current transparency problems, is being considered closely by the Commission. The cost of data and its evolution as a result of MiFID II are another important element being assessed. The challenges of implementing a consolidated tape however also need to be taken into account. Ensuring a sufficient quality of data is essential, as well as defining an appropriate governance and remuneration model.

An industry representative stated that the establishment of real-time post-trade consolidated tapes ensures that investors can efficiently access transparency data. This is true for both equities and non-equities, but is particularly relevant in the non-equity space. The key features of any post-trade consolidated tape are that it is comprehensive, with a mandatory contribution from trading venues and for the activity conducted outside trading venues, that information is disseminated immediately upon receipt and that it features a targeted and limited deferral regime for larger block trades.

A regulator added that best execution is also important in the context of the consolidated tape. Best execution and smaller spreads are key features both for institutional and retail investors and currently are not delivered.

Another industry representative stated that the consolidated tape is a matter of implementation rather than of objective. The market agrees on the need for a consolidated tape and the transparency that it affords. A market observer added that the CMU HLF had not been able to achieve a consensus position on the consolidated tape. That is because there are different views on the detailed measures needed for implementing it and there are also significant economic interests involved.

2. Enhancement of the EU securities and derivative market structure

2.1 Ongoing changes in the post-trading regulatory framework

A policy-maker explained that the Commission's priority is to implement all of the legislative changes that have been agreed and adopted over the last 18 months concerning post-trading market infrastructures.

There are many legislative projects underway in the clearing and settlement areas. The EMIR Refit Level 2 delegated acts on fair, reasonable, non-discriminatory and transparent (FRANDT) contractual decisions will be adopted in the autumn. The report on postponing the clearing requirement for pension funds will be sent to EU institutions this month. The three delegated acts under EMIR 2.2 on tiering, fees

and comparable compliance are awaiting agreement from Council and Parliament. A new CCP Supervisory Committee is being set up within ESMA. The EU CCP Recovery and Resolution framework was also agreed in Council and will be voted in Parliament in a few weeks.

The Commission is also required to prepare 16 reports to the European Parliament and Council over the next 24 months, covering a wide variety of issues. Some examples include the EMIR reports concerning issues such as central bank exemptions, pension funds, exchange-traded derivatives (ETD) reporting calculations, aligning clearing and trading obligations, post-trade risk-reduction services and interoperability. There is also a report on whether ESMA should be dealing with the supervision of EU CCPs, beyond systemic third-country ones.

The Securities Financing Transactions Regulation (SFTR) will also be assessed in order to evaluate whether it works and whether the fees are appropriate. The Settlement Finality Directive and the Financial Collateral Directive will also be reviewed, as well as the CSDR taking into account input from the member states and other stakeholders, the policy-maker added. Concerning the CSDR, elements such as the authorisation process, the cross-border service provision, settlement internalisers and settlement discipline rules will be discussed in particular. The coming into force of the settlement discipline measures has been delayed to the beginning of next year in view of the issues observed during the beginning of the pandemic, and ESMA was asked to draft Regulatory Technical Standards (RTS) postponing its implementation further to 2022. The Commission is also working on options for equivalence decisions in this area in order to mitigate the issues linked to Brexit.

An industry representative noted that one additional important, non-policy element from a CSD perspective is the discussion around the EU recovery package, which means that there will be mutualised debt issuance by the Commission in the future. This is an important change for CSDs, because usually sovereign debt is issued in national CSDs. The question will therefore be where this supranational debt is issued and whether this will be in more than one CSD.

2.2 Progress made in terms of financial infrastructure

An industry representative stated that progress has been made with the regulations implemented in the post-trading space. In the current Covid crisis and other past crises, financial infrastructures have risen to the challenge: for example, massive increases in volume in terms of securities transactions in the last few years and the recent move to working from home experienced with the Covid crisis. Concerning post-trade derivatives reporting, the position now is 'lightyears away' from that of 2014. Volumes have increased massively, costs have decreased in equivalent scale and the quality of the data and the frequency of reporting, have greatly improved. All of that has been achieved seamlessly, which is partly due to the regulations put in place since the financial crisis that have given a structure within which to work. The regulations have also evolved over time to become more efficient and relevant. The question is however whether 'sufficient' progress has been made. By any measurement, there is still plenty of room for improvement in the post-trading area, the speaker believed.

A market observer agreed that more progress is needed particularly for the CMU. The efficiency and safety of market infrastructures, which is a key element for CMU, still needs improving. Some of the fragmentation issues raised by the

Giovannini group in the settlement space twenty years ago are still being debated. There are still concerns on the prudential side regarding CCPs. One question is whether the recently adopted recovery and resolution framework for CCPs and the default waterfall that is part of it can work in all circumstances.

2.3 Proposals made by the CMU High Level Forum (HLF) for reducing fragmentation

An industry representative considered that there are common themes running through the High-Level Forum report, the first and second Giovannini reports, and the European Post Trade Forum report that was published during the previous stage of the CMU: harmonisation of tax, harmonisation of corporate actions, harmonisation of data standards and provision of access to data. It is hoped that Covid and Brexit will be catalysts for making progress on these issues, which are key for the CMU. The HLF is also a stronger basis than previous reports for moving forward in these areas. In CMU the key word is 'union' and it means all working together to create one single solution. There have been talks about the move from directives to regulations to support the implementation of a single rulebook, but the recently adopted SRD II (Shareholder Rights Directive) is a directive, leading to potential variations in its transposition into local law, which is not helpful. Another priority is the better integration between the individual pieces of regulation and better coordination between regulators.

A market observer explained that concerning market infrastructures, the High-Level Forum had concentrated on three areas where further harmonisation is needed. First is the fragmented provision of settlement services discouraging cross-border trading. The Commission is urged to come forward with a proposal mid-2021 with targeted improvements to CSDR measures aiming to facilitate settlement across borders (with a more harmonised application of passporting rules, enhanced supervisory convergence). The ECB and national central banks are also invited to consider facilitating access to non-domestic central bank money within the EEA. The second proposal is to alleviate problems relating to the cross-border exercise of ownership rights. Proposals were made concerning the harmonised definition of shareholders and the clarification and harmonisation of interactions between investors, intermediaries and issuers and also the use of technology. The third aspect relates to cloud services, for which the development of standard contractual clauses was proposed in order to facilitate effective supervision and the monitoring of risk and to make sure that cloud service customers are aware of the legal implications. These are feasible recommendations that will make a difference. A key aspect of the CMU is however that all the actions proposed are inter-dependant. Unless the full, integrated CMU package including all the infrastructure points discussed are implemented, the expected results will not be achieved.

Another industry representative was supportive of the proposals of the CMU HLF but suggested two further areas of work. First, it would be beneficial to assess the open-access provisions included in MiFIR, EMIR and CSDR and to identify whether they have effectively met their goals, considering the co-existence of horizontal and vertical infrastructure models in the EU. One issue is that these provisions have been scattered across these different regulations, which makes the stock-taking exercise more difficult. A second point is the upcoming CSDR review. The industry representative believed that this review should be limited to the cross-border elements of the regulation such

as cross-border settlement and passporting, which have regressed with some unnecessarily burdensome measures. But there is no need for a significant overhaul of the CSDR. There is for example the intention to determine whether the settlement discipline regime needs revision, although it has not yet been implemented. In addition, examining the mandatory buy-in requirements in case of settlement fails is more a request made by investment firms.

2.4 Further areas of improvement

2.4.1 Enhancing supervisory coordination and convergence

An industry representative suggested that moving towards a single securities regulator is a clear and easy target to hit and should be a priority for the EU, although there are tensions between this proposal and the powers of individual member state regulators.

A regulator confirmed that some domestic authorities are very much in favour of further European integration and perceive the added value of the European Supervisory Authorities (ESAs) including ESMA. Supervisory convergence is very important and efforts to increase central supervision at the EU level should be pursued. This capacity at central level should be used in particular for advising those who need to make the decisions at the EU level, be it the Parliament or Council, or at the national level, and to have this capacity in-house within ESMA. Less fragmentation and a better-functioning European market is in the interests of all member states and all citizens within Europe.

2.4.2 Improving data collection and management at EU level

A regulator noted that data collection is an area that can be far better organised in a central place. Europe has to improve data quality and the exchange of data between regulators, and needs more centralised data collection. This concerns pre- and post-trade data as well as central reporting with, for example, the single access point to company financial and ESG data at EU level proposed by the CMU HLF previously mentioned. At the very start of MiFID II, there was a huge investment in data-collection capacity. Some member states for example Norway, Sweden, Finland, Denmark and the NL worked together on building and testing a common system. In terms of cost and performance, very satisfactory results have been achieved. Therefore more European centralisation and supervisory convergence are worthwhile objectives.

An industry representative agreed that data can be much better organised in a central place. Data collection and storage are at present fragmented within the EU and also on a global basis with the US and Asia. There are differences also in the form in which data is stored. That fragmentation makes it difficult for the regulatory community to achieve the stated goal of the 2009 Pittsburgh Summit, to bring greater cross-border transparency to the OTC-derivatives market in particular. Transparency within regions has improved but, between regions, it still needs to be worked on. Moreover, the goal of the EMIR derivatives reporting piece was transparency and usability, and not to achieve a competitive reporting landscape within the EU, which is not a helpful outcome. That regulation could be looked at in a different way. ■