

# MiFID II / MiFIR review priorities

## 1. Overall objectives of the MiFIR review and key issues at stake

The Chair noted that the Markets in Financial Instruments Regulation (MiFIR) review is underway. The UK proposal on the same issues is expected in the coming weeks as a follow-up to the consultation on the Wholesale Market Review (WMR). Enhancing transparency and price formation are at the core of both of these initiatives. For the EU, a number of important issues are covered by the MiFIR review including: the definition of a consistent approach to waivers and deferrals, the role of systematic internalisers (SI), the implementation of consolidated tapes, the acceptability of payment for order flow (PFOF) and ultimately how best execution and efficient price formation may be achieved.

An industry representative emphasized the importance of contextualising the MiFIR review debate in the EU macro-economic environment. Currently there is a risk of durable high inflation and very weak economic growth in Europe, together with unprecedented levels of public debt and constrained public finances. In this context, developing capital markets is essential to advance on the ESG and digital transformations, and also to solve key societal questions for EU citizens such as the future of pension systems. However the development and integration of capital markets in Europe are at a standstill. Of the 1,800 initial public offerings (IPO) globally last year, only 10% took place in the EU. In terms of market cap of listed companies compared to GDP, the US is roughly at 150% while the EU is at around 52%. Fragmentation is also prevalent in the EU with about 500 trading and execution venues compared to about 100 in the US, which is a larger market. The MiFIR review is critically important for improving the structure and functioning of EU capital markets, the industry speaker stated and the legislative proposals from the European Commission on the MiFIR review are a good starting point in this regard, also bringing in some broader thinking on the financial autonomy and competitiveness of the EU and the importance of capital markets for the EU economy.

A regulator observed that the work on the MiFIR review is part of the broader context of the Capital Markets Union (CMU) initiative aiming to develop, enhance and further integrate EU capital markets, which is essential for the growth and resilience of the EU economy.

## 2. Level playing field among trading venues

A regulator considered that a key objective of the MiFIR review should be to achieve a level playing field among the different types of execution venues that are really

'multilateral' and to do so with a future-proof approach. Indeed, after the first years of implementation of MiFID II it was identified that a significant number of equity transactions are still not executed on lit markets, which needs to be addressed. In addition, some systems that allow the pre-arranging of buying and selling orders represent a threat to the level playing field and to transparency.

The regulator also stressed that Systematic Internalisers (SIs) should not be subject to exactly all the same MiFIR rules as multilateral venues. SIs that deal on own account are intrinsically different from other trading venues, because they face different underlying risks, although their activity appears to be quite similar. Although there are nuances across instruments, for many transactions executed by SIs the underlying products are not that much standardised or liquid. Notably for derivatives, the tailor-made trades executed by SIs serve the purpose of specific needs, are out of scope of the derivative trading obligation, and are of limited interest for the price discovery process. Imposing full transparency to SIs may expose them to liquidity and trading risk in connection with possible herding or opportunistic behaviour by other market operators. This could in turn hamper the function of sustaining liquidity that SIs normally perform. The Chair noted that the proposal had previously been made to limit the scope of SIs to large-in-scale trades, which would simplify transparency issues, solve the problems posed by Payment For Order Flow (PFOF), and ultimately enhance price formation. Simplification regarding double volume caps, that are too complex, would also be welcome. In any case, equity and non-equity must be distinguished in addressing these questions, the Chair underlined.

An industry representative emphasised that preserving a sufficient diversity of trading mechanisms is essential. Level playing field measures may impact the competitiveness of EU capital markets, if they restrict too much the choice of execution venues or how they may be used. Investors indeed optimize their choice of venue depending on the size and type of transaction, which means appropriately calibrating the requirements imposed on venues so that users are not penalized. Sufficient choice in terms of execution venues also contributes to fostering competition and decreasing execution costs for end investors.

Another industry representative confirmed that for equities the proportion of transactions executed on lit venues is limited in the EU, where it amounts to 35 to 50% of volumes compared to 60 to 65% in the US and about 80% in Japan. The EU trading landscape is also very fragmented with a significant share of internalisation of flows, which also has impacts on post-trading, with a high proportion of settlement fails.

The industry speaker moreover considered that the MiFIR review measures to enhance the level playing field among

trading venues will not limit competition or investor choice. The different types of trading venues established by regulation should correspond to different investor needs and be subject to tailored rules. Concerning SIs for example, it is important to bear in mind that the initial objective of these venues was to handle large institutional orders in order to avoid market impact. However assessments conducted by the French Autorité des Marchés Financiers (AMF) have established that the median order size on SIs is lower than €6,000, which is quite far from the original intention of SIs. Changing the definitions in the directive regarding multilateral trading is therefore welcome, although proper enforcement will be key. Care should be taken also to capture the market holistically and not allow for new loopholes to develop. For example frequent batch auction-based systems could create new loopholes and their development should be closely monitored.

## 3. Transparency requirements

### 3.1 Opportunities and challenges associated with the enhancement of transparency

A regulator stated that there is a need to increase transparency particularly in the non-equity market and for post-trade data. Opaque markets are indeed a threat to financial stability as demonstrated during the 2008 financial crisis. Although measures to improve transparency were taken, a report issued in 2019 highlighted that a complicated deferral regime under MiFIR, along with the fragmented publication of transaction information, decreased transparency in the bond markets in Sweden. In March 2020, Sweden experienced a fund run, due to the malfunctioning of the underlying corporate bond market, which was basically opaque. A large number of investors tried to take their money out of corporate bond funds, which were trying to sell their assets in the market and subsequently 40 mutual funds had to be temporarily closed. Since then, Sweden has started a reform agenda for the corporate bond market. The Swedish authorities have initiated measures to improve post trade transparency by working with the industry to adopt an industry agreement where they voluntarily publish aggregated information about transactions end of the day. Transparency should be a guiding principle in the review of MiFIR, the regulator emphasized because otherwise the effectiveness of the EU capital markets will be reduced and some players will exit the market at a time when EU capital markets need to develop post-Brexit.

An industry representative agreed that there needs to be more transparency for fixed income and derivative transactions in the EU. Another industry representative was also in favour of enhancing transparency in EU capital markets, but observed that transparency measures could have a negative impact in certain areas of the market, such as a reduction of market liquidity and an increase of costs for end investors if they are not implemented in a balanced way in terms of speed and scope. The mistakes of the initial implementation of MiFID II which had very ambitious objectives in terms of pre- and post-trade transparency,

but ultimately failed to deliver meaningful transparency, should not be reproduced. Although the information on transactions is published, it is fragmented across multiple venues and provided in different formats so it cannot be consolidated and is not usable.

A regulator noted that banks usually claim that there is a trade-off between liquidity and transparency but, for the most part, increasing transparency will lead to more liquidity as it will make the markets more credible and foster consumer protection, attracting new investors. Another regulator however observed that this trade-off may exist for certain types of venues such as SIs, as illustrated by the previous comments made.

### 3.2 EU consolidated tape (CT) proposal

A regulator considered that the CT proposal of the MiFIR review is a step in the right direction, but may not be sufficient to provide an appropriate level of transparency in the market. One issue is that there is still some uncertainty as to how the CT will function and whether a private sector solution will emerge or if ESMA will need to step in.

An industry representative stated that the CT will provide a consolidated and real-time view of transactions, which will help to make a better use of the available information. This will benefit investors, including retail investors, who should be a focus of this initiative, and also regulators for designing data-led policies.

Another industry representative emphasized that a CT has the potential to support further investment in the EU, provided certain conditions are respected. Data quality and availability is a first condition and will not be solved solely by a review of deferrals and waivers and by the implementation process of a CT. The main issue concerns SIs, dark pools and other non-lit parts of the market for which data is not readily available. Secondly, an adequate use case needs to be defined for the CT. The rationale and approach for a CT has to be defined for each type of instrument, depending on the market structure. A CT for OTC derivatives makes sense because in the EU 92% of derivatives trading is OTC with insufficient transparency. However, the situation is different for equities, where data quality issues are mainly focused in certain areas of the market, such as SIs and dark pools, which need to be tackled first, as previously mentioned. In addition the publication delay in the CT needs to be carefully considered because a close to real-time tape for example could potentially favour robots over human investors. The Chair agreed that greater data quality is key for the usefulness of the CT, because this will ensure that a greater amount of relevant information is embedded in it.

A third industry representative considered that, generally speaking, the more real-time the CT is, the more valuable it will be. For retail investors the ability to actually see the post-trade execution data in close to real-time would be incredibly helpful, because this information is not available at present for them, which undermines best execution. A real-time post-trade CT would also help to even the playing field between exchanges and SIs and probably encourage more on-venue trading. The CT can moreover contribute to the resilience of capital markets. Having a post-trade CT during exchange outages is indeed very

helpful for the market to figure out where the price is for example. However, 'real-time' can be interpreted in different ways for different asset classes. For equities it would be seconds but for fixed income about 15 minutes is likely to be the right measure.

The industry speaker added that the EU CT proposal, as it is currently framed, should be relatively uncontroversial because it is limited to post-trade reporting. This should not impact exchanges that much, because the vast majority of market-maker fees paid to exchanges are for pre-trade data and smaller exchanges may actually benefit from the CT because it will increase their visibility. In terms of business case, potential CT providers (CTP) will be interested in setting up a CT provided the reporting to the CT is mandatory and free.

### 3.3 Deferral regime

A regulator stated that the post-trade deferral regime should be simplified because the current system, based on different criteria such as sizes and ratings, is too complicated. The US TRACE (Trade Reporting and Compliance Engine) system, which publishes prices of bond transactions with a 15-minute deferral, could be a source of inspiration. European market players often consider that reducing deferrals would make market-making impossible, but such transparency would on the contrary help to increase the liquidity and the credibility of the market.

An industry representative considered that the current proposal to reduce post-trade deferrals is too inflexible. For certain pockets of the market where instruments are quite illiquid and where transactions are large, a two weeks' deferral for volume and end of day for price publications will not be sufficient. TRACE is not a real reference for the EU because it has a narrower scope than MiFID; it is mainly focused on US-denominated corporate bonds and does not introduce any real-time transparency for US Treasuries. It is moreover surprising that the Commission's proposal includes a harmonisation of deferrals for corporate bonds but not for sovereign bonds.

An industry representative explained that Treasuries are reported to TRACE in the US but transactions are not made publicly available. This situation should not be reproduced in Europe. Given that Treasuries are one of the world's most important markets, there should be greater transparency and the Federal Reserve and the US SEC are taking steps at present to address this issue. There are legitimate reasons to have some delay in reporting in certain cases, particularly to afford hedging, and price and volume should be treated differently in terms of deferrals. There can be a 15-minute delay for price reporting and a longer deferral for volume reporting e.g. 48 hours or some reasonable amount of time. The proposals of the Commission seem quite adequate in this regard.

A regulator considered that deferrals should be limited in liquid markets, so the argument for deferrals holds more for corporate bonds than for government bonds. The deferral regime should also change for government bonds

to make it more transparent. Another regulator noted that while being more liquid, sovereign bonds are less amenable to fast monetisation in the view of the European Commission. The deterioration of liquidity is also probably a bigger threat for sovereign bonds than for corporate bonds, because they are more exposed to different destabilising factors (e.g. credit ratings, credit default swaps, ... as the past experience demonstrates).

### 3.4 Fine-tuning of the MiFIR transparency regime

A regulator acknowledged at large the need to further fine-tune the current MiFIR transparency framework beyond reconsideration of waivers and deferrals, for instance to improve transparency of quotes made available by SIs. However, the new requirement for SIs to publish firm quotes for equities relating to a minimum of twice the standard market size seems to go too far, as moving the threshold from 10% to 200% seems excessive<sup>1</sup>. Following a specific question by the Chair, the regulator also replied that the proposed simplification of the double volume cap system is welcome.

An industry representative added that the accumulation of changes proposed in the MiFIR review needs to be carefully thought through, bearing in mind the balance between liquidity and transparency. There are proposals to increase real-time post-trade transparency while also increasing pre-trade transparency by removing the size specific to the instrument (SSTI) exemption and at the same time the phased-in approach for both derivatives and bonds is being removed.

Another industry representative was favourable to moving to a single volume cap, maintaining only the EU-wide threshold, is adequate since the double volume cap is not functioning properly. The increase for SIs of the pre-trade quotation size to two times standard market size for publication requirements is welcome, as are the changes to the reference price waiver to avoid the matching of smaller trades at midpoint. Moreover, a ban of payment for order flow (PFOF) is needed. A work by the French AMF based on real transaction data has indeed identified execution services which involve a part of retail flows being diverted from lit markets to the benefit of the handful of institutional investors that are members of the various programmes targeting retail investors, with strong evidence that end-customers are often disadvantaged.

## 4. Competitiveness of EU capital markets

### 4.1 Share and derivative trading obligations and open access measures

A regulator stated that concerning derivatives the objective put forward by the Commission to strengthen EU central clearing is valid from a competitiveness standpoint, as well as the proposal to align the scope of the clearing obligation under EMIR and of the derivatives trading

1. At present SIs are required to make public, on a regular and continuous basis during normal trading hours, firm quotes for equity and 'equity-like' instruments when there is a liquid market. Where there is no liquid market, SIs must disclose quotes to their clients upon request. The requirements apply only when dealing in sizes up to standard market size. SIs are able to decide sizes at which they will quote, provided they are at least 10 per cent of standard market size.

obligation (DTO) in MiFIR. This objective is justifiable on technical grounds, as the contribution to the price discovery process and the benefits of the straight-through processing for transactions that occur on exchanges do materialise for derivatives with marked features of standardisation and liquidity, which are the ones already subject to the clearing obligation. From a more strategic perspective, keeping these transactions in the EU market could also contribute to building up the EU clearing capacity.

The regulator was moreover in favour of keeping some flexibility in the process of activating a possible suspension of the derivative and share trading obligations (DTO and STO) in order to be able to cope with market disruptions. The flexibility available for suspending the STO proved very useful for tackling the challenges connected to Brexit for example. However, while the exemption foreseen for non-systematic, ad-hoc, irregular and infrequent transactions should not necessarily be maintained as it is, given it could prove very general and difficult to enforce, a certain degree of flexibility in the suspension of both the DTO and the STO would be beneficial. In particular, the possibility of suspension of the STO could be modelled along the lines already proposed by the European Commission for the DTO. Such suspensions could be activated by a single national competent authority (NCA), possibly in coordination with other NCAs and also ESMA, to ensure convergence of approaches. Maintaining this power to suspend the DTO and STO on an ad hoc basis is also important because the EU authorities do not have the possibility to adopt no action letters in the same way as authorities in some other jurisdictions.

An industry representative agreed about the proposal to align the scope of the DTO with that of the clearing obligation. The industry speaker also stressed the importance of deleting the open access framework. No other jurisdiction has such a framework in place and its elimination is currently being considered in the UK. Open access may indeed hinder market competitiveness because if all of the trading venues and CCPs are linked up, then there is access to all of the other services and products, which reduces incentives to compete on the basis of better services and products and cheaper prices. In addition, on the clearing side, it is important for financial stability that clearing should be as centralized as possible rather than interconnected. Open access rules also need to be considered in the context of future market developments, as they may make it more difficult for certain market infrastructures to move to a Distributed Ledger Technology (DLT) environment, which may have further implications for the competitiveness of EU markets.

The Chair observed that the topic of the competitiveness of EU capital markets is potentially more sensitive for bonds, for which there is no trading obligation, than for derivatives which is a truly global, international market.

#### **4.2 Impact of MiFIR review transparency proposals on the competitiveness of EU capital markets**

Answering a question from the Chair about the possible impact in terms of competitiveness of the MiFIR review transparency measures for bonds in particular, an industry representative considered that the current deferrals are too limited to cater for the very wide scope of instruments

that come under MiFID II with different liquidity characteristics. For sovereign bonds, MiFID II covers any sovereign bond that is traded or needs to trade in Europe. This regime does not currently cater for all of the different liquidity profiles that will be seen in those instruments. There is a real risk that the EU could be at a disadvantage as a result of the measures proposed.

An industry representative stated that generally speaking more transparency will lead to more competitive and resilient markets. The US grappled with the same questions about post-trade transparency and whether to implement a close to real time reporting system about 8 years ago and academic studies have since shown that spreads tightened for institutional investors by about 10%, more entrants came into the markets with smaller dealers enhancing competition and the overall market volume did not decrease. This shows the positive impacts of transparency measures in the US market, which is however only one reference point.

#### **4.3 Comparison with the UK Wholesale Market Review (WMR)**

An industry representative noted that although the end result of the WMR is not yet known, the direction of travel is different than in the EU. The UK is taking a more liberal approach, proposing to eliminate certain requirements that do not provide end investors with appropriate outcomes such as the shares trading obligation and the double volume cap. There is also a different approach to dark trading, which the UK perceives as potentially playing a positive role in certain pockets of the market. Concerning pre-trade and post-trade transparency, the UK Treasury considered in a recent consultation paper, that the specificities of equities and non-equities and how liquidity is created in those markets are not sufficiently well taken into account in MiFID II. They are notably looking to potentially restrict pre-trade transparency obligation in the UK in the fixed income and derivatives markets to only automated order books. The UK Treasury is also proposing to provide regulators with more power and a secondary objective around economic growth and competitiveness, which Europe should also consider.

Another industry representative added that the UK Treasury indicated that they would start with a post-trade CT in fixed income and in OTC derivatives as that would have the biggest potential benefit. While there should be consideration of what the UK is doing, if it takes a step back from transparency then Europe should not follow it.