

MIFIR review: pending questions

1. The Consolidated Tape Provider (CTP) proposal

1.1 Objectives of the CT and expected benefits

The Chair noted that the negotiations between the co-legislators on the Markets in Financial Instruments Regulation (MiFIR) review proposal are in their final stage. The proposal to implement a CT for equities, bonds, derivatives and ETFs is a key element of this proposal.

A public representative emphasised that the intention of the MiFIR review is not to codify the past, but to allow capital markets to expand in order to channel capital where it is most needed. One of the areas where capital is most needed are innovative firms and projects contributing to the green and digital transformations. Innovation in these areas is supported in part by public funding, but private funding provided through the capital markets is also essential. An effective regulatory framework is necessary to support the development of capital markets in the EU, covering areas such as the provision of market data, which is essential for the functioning of capital markets. The consolidated tape (CT) proposal is therefore a cornerstone of the Commission's MiFIR review proposal. If the CT is designed properly it will provide incentives for cross-border investment and will deliver meaningful and easily accessible data for investors.

The public representative explained that the European Parliament's position is that all asset classes need to be covered by the EU CT. A phased implementation of the CT has been agreed in Parliament, starting with bonds and there could be a similar agreement in the Council. The initial idea was to start with equity because an equity CT is easier to implement, but it was finally decided to start with bonds, followed by equity then derivatives. A regulator considered that the proposed sequence, starting with bonds, then equity, then derivatives and ETFs seems the right approach for implementing the CT.

An industry representative noted that the equities and exchange traded fund (ETF) tapes will also be a valuable tool for market resiliency, because they will lessen the dependency on any one single venue with a constant stream of market data that can support trading.

A second industry representative stated that consolidating market data and bringing transparency to the market has tremendous value. Stock exchanges have significant experience in these areas and can contribute to this objective. However data on its own is not sufficient to develop capital markets, attract investments to Europe and channel capital to where it is most needed in the economy. There are many other issues to tackle such as tax, legal and post-trade implications that all need to be

addressed in a holistic way. When the Nordic and Baltic exchanges were consolidated one of the objectives was to facilitate investments coming from the Nordics to the Baltics, but more than 10 years after this consolidation, no Nordic countries allow trading in the Baltics, despite having the same trading system and the same data feed on the Nordic and Baltic exchanges.

1.2 Key elements of the equity CT proposal and pending issues

A public representative explained that in the Parliament's view, the equity tape should cover real time, pre trade data up to the first five layers of the order books, in addition to post-trade data. When entering the dialogue, the position of the Council was different, calling for an equity CT that only shows pre trade data together with post trade data, therefore with a delay. Evidence gathered by the Parliament and discussions held with potential users show that the inclusion of real-time pre-trade data in the CT is technically feasible. It will also maximise the value of the CT and will serve more use cases, particularly critical use cases such as liquidity risk management and trading and portfolio management.

An official highlighted some pending questions related to the equity CT raised in the Council's position. One of the main questions is whether real time pre trade data is needed from the start for the equities CT, or whether it can be introduced later on. The Council supports a two-step approach on the equity CT, starting with post-trade data only, including top of the order book and best offer data in the form of a snapshot at the time of execution, leaving time to further reflect on the inclusion of a pre-trade CT. The data would be delivered as close to real time as possible. A post-trade tape would already be a major step forward for the EU and answer many use cases other than trading, such as providing a consolidated view of liquidity and the possibility to verify best execution requirements. A post-trade tape would also avoid the concerns around data quality and latency that have been raised regarding a pre-trade tape. There are serious concerns due to latency in particular, because of the high number of trading venues in Europe and the long distances that separate them. This could result in providing a false benchmark that could be misleading for investors, particularly retail investors. In any case, it is a very good signal that major trading venues in Europe have agreed to establish a joint venture to implement a close to real-time post-trade CT and deliver data.

An industry representative considered that for the equities CT, starting with the setup proposed by the Council seems the right approach and is a viable way forward. The first step should be a close to real-time post-trade tape, including the European Best Bid and Offer (EBBO) snapshot. Further steps may then be elaborated based on that experience, possibly extending the CT to pre-trade if necessary, but how that may be

done needs to be further assessed. The CT needs to be fast to implement and cheap for users. An ESMA study concerning a possible pre-trade CT clearly underlined that a real-time CT is a much more complex setup, with higher IT costs and higher costs for the users in the market, and also with a much longer implementation horizon. Data quality is an issue also. One of the reasons why a viable CTP did not emerge following the initial MiFID II requirements was the insufficient level of data quality, especially coming from alternative execution venues such as systematic internalisers (SIs). 90% of the data of SIs is now available within the first 30 seconds after the trade execution, but 10% is still missing. The industry representative agreed with the previous speaker that latency is a key issue on the pre trade side. There is a risk with a real time pre-trade CT of building a two-tier market in Europe where front running may be possible. There is also a question about the usability for humans of a pre-trade tape with constantly changing prices. This may only be useful for computer-based trading.

A second industry representative noted that latency is a much greater issue in European equity markets than in the US, because of the fragmented geography in Europe. In the US there are much fewer data sources. Many firms have said that they will not use the tape to trade due to the latency. If a real-time pre-trade tape is implemented it will create an unlevel playing field in the market. The tape also needs to have true transparency, which means having 100% of the trades and bids, including non-price forming transactions, so that all transactions can be seen by all market participants.

A third industry representative considered that the announcements made in recent months by various consortiums of exchanges and trading venues that they would be participating in the competitive tender process to be a CT provider is a positive development, because it further evidences the viability and validity of embarking on the project. While there is a debate regarding the equity and ETF tapes about the inclusion of pre-trade data, it is important to note that the final negotiating positions from both Council and Parliament contemplate collecting pre trade data in real time. There is then a question of whether this data should also be disseminated in real time or just after, together with the post-trade data. If the infrastructure investment to collect pre trade top-of-book data from all the exchanges and multilateral trading facilities (MTFs) across the EU is being made, the speaker felt that this data might as well be disseminated on a real time, pre trade basis in order to maximise the return on the investments made. That was the approach used in the US for the equities and options markets.

A fourth industry speaker mentioned that time-to-market issues need to be closely considered to be able to implement an effective CTP. There is significant pressure to bring a CTP to market very quickly. That is not a major technical challenge, because the activities of collecting, aggregating and discharging the data as a data feed are similar to those currently performed by approved publication arrangements (APAs). The potential challenges will come from the regulatory requirements that will be imposed on CTPs and the interaction with ESMA that remains to be defined.

A regulator suggested that the optimum may be the enemy of good. The CTP project needs to move on and in that perspective an agreement on the objectives of the CTP is needed. If the objective is to implement a system that allows having an understanding of prices and liquidity across Europe for a given stock before the checking of best execution then a post trade CT that embeds pre trade elements, as proposed by the Council, is sufficient.

1.3 The specificities of non-equity markets for the CT

A public representative observed that most of the discussion about the CT has focused on the equity CT so far, but the tape is also very important for bonds and derivatives, because those asset classes continue to suffer from a lack of transparency.

An industry representative stated that the specificities of fixed income markets need to be clearly taken into account in the MiFIR review CT proposals, because equities and fixed income are two very distinct markets with very different requirements for bringing a successful CTP to market. This raises an issue of prioritisation, because while it has been recommended that the bond CT should be the first one brought to the market, its specificities have still not been properly considered in the current dialogue discussions, which are mainly focusing on the equity CTP.

The industry representative added that for corporate bonds, post-trade data has much more utility than pre trade data, given the limited frequency of corporate bond transactions, but for sovereign bonds pre-trade data has significant utility. The transparency of EU sovereign bond markets also needs to be improved to enhance the competitiveness of EU capital markets, in line with the efforts currently being made in the US to increase the transparency of US Treasuries.

An industry representative suggested that transparency needs to be improved more for bond and derivatives markets than for equity markets. Bond and derivative markets not only require a CT, but a rationalised and harmonised deferral regime so that there is useful and timely information to disseminate in the tape.

A regulator noted that there is a discussion concerning non-equity markets around whether the CT should also take care of the full function of harmonised deferral regimes and whether to embed it or not. That would be much more complicated, so that issue should be addressed separately, aiming for a full harmonisation of deferrals regime. In addition the sovereign bond market is already quite concentrated and transparent. Supervisors know where prices are formed and how the market functions, so increasing transparency does not seem to be a major priority.

1.4 Revenue distribution and sharing issues related to the CT

A public representative stressed that the unintended consequences of the tape for EU stock exchanges need to be addressed so that they can continue to play a critical function in the European markets. Both the Parliament and the Council are committed to introducing safeguards related to the revenue sharing mechanism and the opt-

out or opt-in mechanism for smaller venues. The tape will also give greater visibility to smaller venues that are currently under-used because of the high cost of market data thus potentially increasing liquidity pools for trading. An official noted that the Council agrees with the revenue sharing mechanism and the carveout for smaller markets and trading venues that have been proposed.

An industry speaker stated that it is important for encouraging effective price formation in the different European markets to make sure that small exchanges do not lose out from the CT. The industry representative added that a better definition is needed of what market data comprises and what providing it on a reasonable commercial basis (RCB) means in the measures being considered. The cost of data usually refers to exchange data, but market data is not just exchange market data, as connectivity also needs to be considered (i.e. the conduits and terminals needed for providing the data). Creating exchange data has a high cost. When exchanges create data products, they use a cost-plus-margin model, but in many cases data is given out for free. Some exchanges allow their members to use the exchange's data for free to trade and provide real-time exchange data to non-professional users for a small fee. Introducing RCB concepts into legal obligations seems inappropriate at this stage, as it would pre-empt the ESMA peer review. Markets are only now adjusting to the RCB guidelines which came in January 2022 and are extremely difficult and burdensome to implement and adjust to for exchanges and for their customers.

A second industry representative agreed that the revenue sharing and coverage of costs aspects are important for the CT project, as well as the definition of RCB, which is currently more a concept than a defined practice. If RCB has to be applied to the CTP or the corresponding market data contributors then a proper definition of RCB will be needed. ESMA will also need the proper competences to ensure the monitoring.

A third industry representative considered that the commercial impact of the CT on exchanges has been somewhat overstated. Exchanges will still be able to sell direct market data feeds to participants who require them for their own purposes, which is also seen in the US. Exchanges in the US do share in the revenue from the CT, and that has sustained exchanges and venues of different sizes.

A regulator observed that providing the right incentives in terms of revenue schemes and opt-in is important also for driving data quality. Data quality is something that cuts across asset classes. Data vendors should be included in the discussion as they are an important gateway in the provision of data on an RCB basis.

2. Market structure and transparency measures

The Chair asked panellists to give their thoughts on the other main issues covered in the MiFIR review proposal including market structure, transparency requirements, trading obligations, and payment for order flow.

2.1 Transparency regime and deferrals

An industry representative emphasised the importance of the deferral regime for non equities and bonds. Getting information about the pricing of these instruments into the marketplace as soon as possible is essential to further deepen and develop the EU bond markets. The principle that should be embraced is one that is embodied in the Parliament's final text, which says that price deferrals should not be beyond the end of the day. ESMA would be empowered to appropriately calibrate that.

The industry speaker stated that a more ambitious and shorter deferral regime is needed for the bond market and the OTC derivatives market in the EU. The euro interest rate swap market is measured in the tens of trillions, if not hundreds of trillions. It is used by pension funds, asset managers and many other end investors who could benefit from having fairer and more competitive pricing. When the US phased in the post-trade transparency regime for its corporate bond market it was done over a three-and-a-half-year period, the industry speaker explained. The subset of securities that it was applied to was gradually expanded and the deferral timeframe shortened. It is now a 15-minute max deferral, and the Financial Industry Regulatory Authority (FINRA) already has a consultation out to shorten that to one minute. Bond markets can work very well with that level of transparency and there are many benefits with respect to pricing, liquidity, removing information asymmetries, promoting competition and deepening market resiliency. The usual counterarguments that dealers somehow cannot efficiently intermediate markets with that level of transparency are untrue. A dealer making the market for a given bond can effectively hedge most of the associated risks, because it is managing an entire inventory of bond positions and it has a number of different hedging instruments available to it with. A dealer does not need multiple days to work out a position because they are able to hedge their risk, often within 15 minutes or an hour.

An industry representative noted that improving transparency is the cornerstone of the MiFIR legislation, but there is a need to be realistic about the possible outcomes. Transparency will be improved but it might not necessarily improve liquidity. It is also unlikely to improve costs. Market data vendors act as a conduit for the producers of market data, such as exchanges, from the source to the delivery. The actual cost itself is collected by the market data vendor to be supplied back to the originator of the cost. Better transparency is not necessarily going to improve the costs, because the cost is always in the hands of the source of the production of the data. The harmonisation of deferrals is positive but there are calibration challenges ahead which should not be overlooked.

2.2 Derivative trading obligation

An industry representative stated that the EMIR derivatives trading obligation (DTO) is a rational approach to the harmonisation that is happening in the over-the-counter (OTC) derivative market. The DTO requires financial counterparties to conclude transactions in standardised and liquid OTC derivatives in scope, only on regulated trading venues. The possibility introduced in

the MiFIR review to suspend the DTO for certain investment firms that would be subject to overlapping obligations when interacting with non EU counterparties on non-EU platforms seems adequate.

A regulator noted that after Brexit there was a migration of the clearing of credit default swaps (CDS). In an emergency situation sufficient powers are needed to have some management of extreme situations. That is something that needs to be addressed with powers at ESMA level.

2.3 Systematic Internaliser (SI) regime and dark trading cap

An industry representative stated that MiFID II was intended to deliver more transparency, especially on equity markets, but the opposite has happened. Transparency has diminished and fragmentation has increased, particularly due to the SI regime, which has created an unlevel playing field. The SI regime was intended for large in scale institutional orders to avoid market impact, which is quite relevant, but the reality in the market is quite different. A study from the French Autorité des Marchés Financiers (AMF) showed that the average execution size of orders on SIs amounted to €37,000, but a more recent report from Liquidnet shows that the average execution size is now only €11,000. This means that there has been an increasing divergence over the years from the initial intention of the SI regime, creating an unlevel playing field in the market. Going forward it is necessary that SIs should be restricted from executing orders smaller than four times the standard market, although this would still be far away from large in scale transactions. In addition, introducing pre-trade transparency on the quotation side is an absolutely critical piece. Mid point matching opportunities must clearly be restricted for all the smaller trades.

A second industry representative noted that a level playing field with SIs is a problem in both equity markets and fixed income. A regulator stated that one must be mindful of what is likely to happen in other European countries on the SI regime. It is important to stay aligned and to reintroduce some qualitative elements in the definition. There should also be supervisory scrutiny, particularly for illiquid instruments, because SIs still represent a significant source of liquidity.

The first industry speaker added that the dark trading cap has received too little attention in the discussion. The double volume cap did not work and the Parliament and Council agree that there should be a single volume cap, but if it only includes the reference price waiver it will be pretty meaningless. The ESMA data clearly shows the usage of the negotiated trade waiver. Up to 25% of all the trades currently run under it, so ambition is needed on this measure. What is needed is a single volume cap (SVC) that ideally encompasses SIs, frequent batch auctions, and generally as much of the market as possible to make it an effective tool. ESMA also needs a very strong and clear mandate to ensure that any future SVC is a meaningful tool to combat disproportionate dark trading.

A public representative agreed that the MiFIR review provisions on market structure are essential, but did not believe that the situation in terms of transparency was so critical in equity markets. The MiFIR review is about creating conditions for all market participants that enable them to contribute and benefit from the framework. On the equity transparency rules the proposal is to empower ESMA to refine the threshold for the use of both reference price waiver, as well as for SI quotes and execution. Parliament also maintains the Commission's proposal of a single volume cap set at 7%, and also mandates ESMA to regularly assess the threshold and the scope of the cap. The Council's position is to remove minimum sizes for the reference price waiver and for size, and sets the volume cap at the level of 10%. At this stage, it is difficult to judge what the final outcome of the joint work of co-legislators will be, because there is no easy answer to the question of the exact best calibration of the different measures.

When referring to transparency the issue of competitiveness is extremely important. The challenge is that the size of the trading can dilute markets. Parliament is mandating the calibration of the volume cap and the thresholds for the reference price waiver and SIs to ESMA, but this must be very carefully done. It must also be considered that different execution venues serve different execution needs. Some investors trade in large sizes and want to avoid market impacts, others want to trade fast and in smaller sizes, and some also combine different trading strategies. Artificially restricting the choice of execution venues should be avoided, as trading volumes could disappear rather than move somewhere else within the EU capital market. Parliament is also proposing to empower ESMA to take more data driven decisions.

Finally, the public representative added that a delicate balance needs to be struck in terms of market structure in order to strengthen European markets as a whole. It is important to introduce flexibility into the system, whatever decision is made on the levels of transparency, on caps and on thresholds, so that requirements can be adjusted at the supervisory level over time according to market evolutions. This can be done through the Level 2 legislation.

2.4 Payment for order flow (PFOF)

An official stated that PFOF - a practice whereby retail brokers forward the orders from their clients to traders in exchange for compensation and make this transparent - is a new business model that has succeeded in bringing retail investors to the market in some member states, particularly younger investors. Any compensation must be transparent, but the question was, whether a ban of PFOF is the right instrument and the decision was made in the Council not to ban it. Possible conflicts of interest can be tackled and addressed through other means.

A regulator observed that some supervisors were initially sceptical about a ban on PFOF. The optionality mechanism proposed has allowed moving towards a harmonised position. Consideration is needed of segmenting the implementation of PFOF by client nature, as envisaged by the Parliament.

3. Wrap up

The Chair wrapped up the discussion by emphasising the need for sufficiently ambitious measures in terms of transparency, market structure and CT to provide an effective market for both investors and companies. ESMA will have much responsibility in the implementation of the different measures of the MiFIR review and stands ready to take them on. There are also operational challenges that need addressing for a successful implementation of the MiFIR review proposals, which will require collective work between the private and the public sectors.