SECURITIES TRADING: MARKET STRUCTURE AND TRANPARENCY EVOLUTIONS

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MiFIR review: the final judgement

The process for the review of MiFIR was long and cumbersome, with some announced overarching goals, on top of which the realisation of the long-awaited consolidated tape (CT), and much resistance from different categories of stakeholders for a variety of interests.

The current political agreement is characterised by a CT for shares and ETFs based on post-trade data but also including limited pre-trade data based on the Council compromise proposal, whereas the CT for bonds remains focused on post-trade data but will be the first to be launched after the entry into force of the MiFIR recast.

For the equity CT it is worth mentioning that: i) it is set to be voluntary for small venues fulfilling some specific conditions, ii) the revenue sharing mechanism for market data contributors to the CT foresees a preferential treatment for small venues, as well as for data related to shares and ETFs which the trading venue admitted to trading less than five years prior to the entry into force of the amending regulation.

Whilst it is understandable that small trading venues are to be incentivised to contribute to the CT, it is less clear why financial instruments with a shorter life should be rewarded and thus valued more than older ones.

Regarding waivers to pre-trade transparency and limits to dark trading, a single volume cap of 7% will apply only for reference price waivers. No limits will instead apply to negotiated trades, differently than before, potentially running counter the objective of expanding lit trading, which was at the heart of the review.

Pre-trade transparency on non-equity instruments is removed for systems other than a central limit order book or periodic auction systems. Additionally, transparency for derivatives is limited only to exchange-traded derivatives and transactions in OTC derivatives denominated in euro, Japanese yen, US dollar or pound sterling, subject to additional conditions, which means that not all derivatives traded on an EU trading venue, especially on organised trading facilities, will be fully transparent. In other words, the non-equity space will end up in less transparent grounds than currently.

The objective of greater harmonisation in the deferrals for non-equity has been finally achieved, taking into account the liquidity of the instrument and the size of the transaction concerned, but according to second level measures to be adopted by ESMA. The sole flexibility allowed is for the competent authority of a Member State to grant additional deferrals for an extended period of time, not exceeding six months, with regard to transactions in sovereign debt instruments issued by that Member State.

The systematic internalisers (SIs) regime is simplified for both equity and non-equity. The amount of minimum quoting threshold for equity, which has been highly debated, will need to be specified by ESMA (now it is twice the standard market size). Finally, SIs will be allowed to match at midpoint without complying with the tick size regime, differently from what is applicable to transactions executed on trading venues.

The expected set up of both non-equity and equity CTs is the best outcome of the lengthy negotiations. Regarding the other measures meant to boost transparency, we need to consider who will benefit from these changes and who will bear the costs.

When considering the details of the measures briefly mentioned above, as result of negotiations, it seems that the non-equity space will continue benefiting of a more favourable treatment in terms of requested transparency, probably in connection with a lower degree of liquidity when compared with equity. However, in countries where transparency requirements for non-equity instruments have been applied rigorously (almost up to the equity level), no such negative consequences on the market liquidity have been experienced. For this reason, the above said outcome does not seem to be ambitious enough, also in comparison with the situation in the US. Additionally, it potentially prejudices further expansion of the equity instruments, in addition to the existing debt-equity tax bias.

Who will benefit from the MiFIR changes and who will bear the costs?

As anticipated, another goal that was announced but seems not having been pursued coherently is levelling the playing field between trading venues and systematic internalizes (of which the possibility for SIs to match at midpoint is a prominent example).

In sum, the revenues of trading venues, especially the larger ones, risk being eroded by the mandatory contribution to the consolidated tape, while at the same time operators in the dark space may have an advantage by having access to enhanced transparency and not bearing its costs.

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Will the MiFIR review lead to more competitive EU capital markets?

Now that a political agreement has finally been reached on the MiFIR review (with further technical details to be worked out), it is important to look at the expected impact on European capital markets. A key question for us to evaluate the political agreement on the MiFIR review is whether it will benefit the competitiveness of EU capital markets. As Brexit has dealt a severe blow to the aspirations of the EU to become a leading capital market in the world (with London as a major financial center now operating outside the EU), it is even more important that major adjustments to the market structure in the EU are beneficial to the competitiveness of the EU markets.

Our assessment is that the MiFIR review is a major step forward, probably even the best feasible advancement in terms of achieving transparent markets but there is some room for further improvement.

As my separate article on the bond CT in this Eurofi magazine argues, we consider the establishment of a CT for bonds an important success: there will be a CT that will add significantly to transparency and execution quality, reducing fragmentation in EU capital markets, increasing visibility, comparability, funding opportunities and improve market resilience. We believe the CT for bonds can play an important role in setting examples for other asset classes.

The CT for equity is next in line. There has been much opposition to the establishment of an equity CT, but the agreement on the MiFIR review endorses the importance of the consolidation of (near to) real-time post-trade transparency for equity. This is by itself already a major achievement and very good news for enhancing transparency in the EU. For the equity CT, we don't believe it will compete with proprietary market data franchises: this business model for trading venues remains unaffected. In return, better visibility and revenue-sharing models could provide a tangible benefit for smaller and less interconnected venues.

Aside from the CT for bonds and shares, there are other encouraging results of the MiFIR review like the measures to enhance pre- and post-trade transparency (e.g., waiver and deferral requirements, rules on systematic internalizers and amendments to the share and derivative trading obligations). These measures on transparency and market structure are each of them strong contributors to meaningful transparency.

The most important additional result from our perspective is however the ban on Payment for Order Flow (PFOF), including only a very limited time for national discretion to opt out of this regime. The agreement should be seen as a ban to buy off competition in the liquidity provision. Retail orders should be able to flow freely to exchanges with full transparency of costs for investors. Retail orders are the "bread and butter" to the whole of the order and trading chain, and they form an essential basis for price formation in the market. It is encouraging that the EU, like other trading centers around the world, is taking the right turn in this.

Taken all together, the establishment of a CT for bonds and equity, the ban on PFOF and measures to enhance transparency are important steps forward for the MiFID II/MiFIR framework to operate successfully and to improve the competitiveness of EU capital markets.

Let us zoom in a bit more in detail. The establishment of the CT speaks for itself. In simple words its establishment will strongly improve transparency and non-discriminatory access to market information and will thereby contribute to the competitiveness of EU capital markets. We expect that the ban on PFOF and measures to increase transparency will also contribute significantly to the EU capital markets operating in a competitive way.

Does the principal agreement on the MiFIR review leave nothing to wish for? Although we are very positive on the outcome of the negotiations, we think there is still some room for further improvement. The most tangible example of that is the consolidation of pre-trade transparency information for equity. The political agreement allows for the inclusion of only very limited pre-trade information in the equity CT.

An enhanced operational MiFID/MiFIR framework is key to competitive EU capital markets.

In our view, investors would be better off with the inclusion of more extended pre-trade information. This would enhance the price formation process and in that way be beneficial to the competitiveness of EU capital markets. We recognize however that this was not feasible, and, in that sense, the current agreement can be considered the best result that could be achieved. The next step is to make it workable and in that respect there is a big role for ESMA in terms of drafting level 2 regulations and the selection and authorization of the CT's for bonds and equity.

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Competitiveness is about more than local companies listing abroad

High-profile cases where successful European companies have decided to float in the US have prompted soul-searching around one question in both the EU and in London: why are we not competitive enough?

This is an important issue to consider – the flow of companies going from the EU to the US is significantly larger than that in the opposite direction. It is understandable that European countries want successful companies to list locally, and that would require more competitive capital markets. This ambition lies at the heart of the capital markets union project. Yet, thinking only in terms of "competitiveness", especially with US markets, risks focusing only on the most visible part of the problem. Putting a magnifying glass on high-profile EU companies listing outside of the Union can obscure a deeper issue lurking underneath the headlines: it is not just that some of the best European companies are going elsewhere, but that there are too many companies in the EU that do not use capital markets at all.

Instead, they rely on bank financing or internal funds. The ratio between debt securities and bank loans for non-financial companies in the US is more than tenfold that in the Euro area. US companies also use equity financing to a greater extent, giving them better access to long-term capital to finance uncertain, possible high-impact ventures. In addition to the likely detrimental effects on economic growth from a dearth of risk-willing funds, the loan-heavy European corporate funding mix reduces economic resilience. The eurozone debt crisis is a striking example of how overdependence on bank loans can exacerbate and prolong downturns. Even if one prefers to think of capital markets in terms of competitiveness, it is difficult to be competitive if you cannot weather a crisis.

There is clearly no conflict between the policies that would attract national success cases to list within the EU and those that would improve capital market access for all companies. On the contrary, the overlap is significant. But it is important to remember that the cost of uncompetitive European capital markets is not just the prestige loss of big names floating abroad, but more importantly a widespread lack of market-based funding. The EU shares in global activity on both equity and debt markets are consistently smaller than the size of its economy would suggest.

The more important cost of uncompetitive capital markets is a widespread lack of funding.

But identifying symptoms is not very difficult. The more daunting task is to diagnose the cause. There is the usual suspect: fragmentation in EU markets, notably caused by a mosaic of different insolvency and tax systems. Lack of harmonisation is a critical issue, but EU-wide measures are not the only tools available to improve market functioning. Much can be done nationally as well.

One notable example is the asset allocation of pension funds. There are large differences within the EU, but on aggregate European pension funds' allocation to equities is much lower than it could be. Pension funds shifting some of their capital from fixed income towards equities, while maintaining prudent investment strategies, would make a significant pool of capital available to companies and help improve capital market dynamism as well as the financial sustainability of the funds themselves.

Another is household exposure to capital markets. Reflecting the dominance of banks, EU households allocate around a third of their financial assets to simple currency and deposits, more than twice the US number. In some EU countries, the share is more than fifty percent. This has the twin impact of reducing both companies' access to finance and households' returns on their savings.

More broadly, the EU economy is not structured primarily around high-growth industries. This is not conducive to capital market growth, especially in a low-interest rate environment like that of recent years, where growth at times seemed to be the only game in town. When considering aggregate IPO proceeds since 2008, the EU's top industry is consumer cyclicals, whereas the US' is technology. The share of tech companies in US IPO proceeds is almost three times that of the EU, and for other high-tech industries like healthcare it is well over twice as large. The figures are even less flattering when looking at absolute amounts – US proceeds in these industries outsize the EU's by seven and six times, respectively. The only sectors where EU proceeds exceed US ones are utilities and telecom.

These are high-level economic and financial issues that require significant political commitment and broad buy-in to address. They will not be solved by fine-tuning at the edges. That does not mean that technical measures related to, for example, a consolidated tape are unimportant – on the contrary, technical improvements are critical to building well-functioning markets. But they make a difference at the margin.

Successful European capital markets require broader and bolder initiatives as well, a focus on the forest and not just the trees.

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MiFIR: what is still needed for the ultimate project for the EU Capital Markets

The entry into force of MiFID II and MiFIR in 2018 was a response to an economic reality very different from the one we are living in today. Since then, significant changes have altered the dynamics of our financial ecosystem. These include the pandemic and the boost in technologies like cryptoassets, DLT, and blockchain, which have become an important variable affecting how participants in capital markets interact. Thus, the review of MiFIR is of utmost importance, as it is the opportunity to assess new circumstances and address the challenges that have arisen.

It is important to highlight that despite the political agreement reached in June 2023, the technical aspects of the regulation are part of a discussion that can and will extend over the subsequent months, and that must not be considered concluded until a solid compromise is reached. In fact, many of the details that fall under the second part of negotiations are just as crucial as the formal political arrangement.

Transparency and proportionality must be the lighthouse of the discussions for policy makers and for industry stakeholders. As the bandwidth of the discussions has lightened now of political tendencies, it is the right time to target the imbalances that appeared as a by-product of MiFIR, and to provide a much more attractive ground for investments and capital to flow into the EU.

Despite its controversy, the ban on Payment for Order Flow (PFOF) is a milestone in achieving a consistent and harmonized trading landscape throughout the EU that can allow us to compete with other jurisdictions that move fast and adapt quickly to new realities. Ultimately, this will translate into better protection for the end client, by offering a fair and clear price, and promoting competition.

Moreover, a fit-for-purpose threshold for SIs, where they fulfil their role without harming an efficient price formation process is indispensable for targeting fragmentation among trading venues in the EU and allowing the end client to achieve the best execution. It is crucial to ensure that the thresholds that determine SIs activity are realistic and do not overflow beyond the scope envisaged in the directive. Otherwise, fragmentation will only increase – leading to a less-optimal performance of markets overall, harming price formation, and resulting in a distorted view of trading occurring in the EU.

Exchanges are an integral part of the financial ecosystem contributing to raising capital and growth.

Furthermore, the application to the SIs of the transparency requirements for the consolidated tape is a guarantee to ensure functionality and usefulness of the tape itself and its role as a tool for permitting distribution of information, and not just a mere dataflow that can only be exploited by a few. This is particularly relevant when considering the overarching objectives of CMU and the goal of increasing access to capital markets to all stakeholders and not just of those who have more technical means.

Other elements, such as waivers, will play a crucial role in ensuring transparency: ESMA is now tasked with determining thresholds for pre-trade transparency, and it is critical that this be done in a carefully considered manner. More precisely, the reference price waiver should not be fed from the output of the consolidated tape, but should remain a threshold on its own.

It is also very pertinent to note the changes proposed to the share trading obligation that have finally reached a compromise where either local or non-EEA currencies are considered in the exemption, which are fundamental to maintaining a solid integration of the EU markets with its third-country counterparties in the region.

Among these open questions, there is one important factor to highlight: Exchanges are an integral part of the financial ecosystem, contributing in a transparent and orderly manner to raising capital and allowing for growth and consolidation of the economy. As such, the qualities of robustness and resilience, proven over periods of distress, have the capacity to add value to the decision-making process. Moreover, the experience provided by long-standing presence in the industry makes Exchanges great partners to supply expertise, technology and reliability when shaping the future of finance in the European Union.

As new horizons draw near for the capital markets, new challenges arise as well: better integration of markets, reducing fragmentation, and fostering fair competition must remain driving forces to improve our markets. While leveraging from new tools shaped with knowledge, technical expertise and assessment from authorities is needed to sustain long-term viable capital markets that permit growth and protect their players: customers, companies, and venues – as it is the path for maintaining and increasing relevance in an increasingly changing and competitive scenario. Thus, the next and final stage of the MiFIR Review is a golden opportunity that must be addressed with proportionality and rationale to provide the EU with a solid project that can attract and retain companies and capital.