Securities trading: market structure and transparency evolutions

The Chair highlighted the main changes in the political agreement reached in June 2023 around the Markets in Financial Instruments Regulation (MiFIR) review. Some measures will need to be further specified in the technical work of the trilogues or at Level 2. A first block of changes concerns transparency and waivers. This includes the elimination of the cap to the negotiated trade waiver and the replacement of the double volume cap by a single 7% cap for the Reference Price Waiver (RPW). The intent is to fully harmonise waivers and deferrals in normal times to eliminate the national specificities, with the notable and surprising exception of sovereign debt.

A Classes of Financial Instruments Approach (COFIA) has been introduced for classifying debt instruments as liquid or illiquid for the purpose of transparency requirements. Some changes have been introduced on the derivative trading obligation (DTO) and clearing obligation, which have been much debated in the context of MiFID. The application of the DTO linked to the transaction being subject to the clearing obligation is an important change. There is also a possibility to suspend the DTO in certain circumstances. An exemption from that obligation for certain firms that mainly trade with non-EU firms was very contentious.

Significant changes have also been seen on the open access regime, especially for exchange-traded derivatives (ETDs), which has been removed in effect. The systematic internaliser (SI) regime has also been amended. There have been changes in terms of mid point matching for orders below large in scale, and in the application of the non-equity pre-trade transparency for SIs or execution methods different from auction systems or a central book. The share trading obligation has also been reduced to 'EU shares'. A ban on payment for order flow (PFOF) has moreover been implemented, with a transition period until June 2026 for countries that currently allow it.

1. Outcome of the MiFIR review proposal

A regulator was satisfied with the outcome of the MiFIR review and the balance that has been achieved in the requirements, with rules that have been added and other that have been taken out or amended. The ban of PFOF that will be progressively phased out until June 2026 is an important measure of the MiFIR review. It was already possible with MiFID II but member states had interpreted rules differently, which created an unlevel playing field. With PFOF it is unclear whether best execution is obtained at a trading venue, since payments for attracting transactions are involved, which is why the best option is to eliminate PFOF. Other key measures include the objective to reduce complexity in the transparency requirements with the removal of the double volume gap and the objective to increase the proportion of transactions on lit markets such as exchanges. It is still uncertain however, whether the measures proposed to increase lit volumes will be effective, notably those targeting SIs.

An industry representative agreed that the effectiveness of the amendments to the transparency regime, such as the simplification of the single volume cap, for supporting lit markets and fostering an efficient price formation will need to be checked and monitored over time. It is also hoped that the measures concerning SIs will have sufficient impact. Those venues have a growing relevance in the market but do not always function as intended. Initially they were meant to handle large orders, but in practice relatively small orders represent a large part of their activity. This creates regulatory arbitrage. In addition the orders traded via SIs are not subject to transparency requirements and do not contribute to the price formation process. The new restrictions that will be imposed on SIs in terms of order size and mid-point matching opportunities should be designed to contribute to improving the level playing field with other venues and to enhancing transparency.

Another industry speaker detailed the expected impacts of the reviewed MiFIR transparency regime for different asset classes. For shares, there is a natural tension between the interest of each market participant, which is to reduce the impact of its orders and their contribution to price formation and the interest of the community, which is to make sure that the price formation process considers as much of the interests that are present in the market as possible. The replacement of the double-volume cap by a single cap and the changes in the rules for SIs should normally bring more flows back to lit multilateral venues and have a positive impact on the price formation process. An issue which is difficult to address however is that the end-of-day transactions represent up to 40% of the volumes on certain days, which hinders the price formation process throughout the day.

For bonds, there is value in the harmonisation of the deferral rules because it is a truly pan-European wholesale market. The level of the deferrals in terms of post-trade transparency is however problematic, notably in relation to other jurisdictions, from a competitiveness standpoint.

For derivatives, the simplification of transparency rules and the move from ISINs to UPIs for the identification of instruments are appropriate. The decision to increase transparency on single name credit default swaps (CDS) for global systemically important banks (G-SIBs) is questionable however, as it had been taken with

limited analysis and an incorrect assumption that insufficient transparency in the EU CDS market fuelled the fall of shares of European banks on 24 March in the context of the Silicon Valley Bank (SVB) and Credit Suisse crises. The problem was in fact due to excessive and inappropriate transparency in the US CDS market. Indeed, the US has transparency on CDS, including on European underlyings, but it focuses on the price and does not specify the seniority of the debt instrument being covered by the CDS, which makes the data difficult to interpret. If this problem subsists in the US, there is not much point in increasing transparency in the EU.

A regulator welcomed the measures proposed in the MiFIR review in terms of harmonisation, simplification and enhancing transparency, including the single volume cap threshold at 7%, a more consistent deferral regime, and amended rules for SI orders. The MiFIR review could have gone further on certain aspects, the regulator felt. An opportunity has been missed to create a full level playing field across the venues that are not multilateral trading facilities (MTFs) but share multilateral features. Different multilateral systems have emerged in the market over the years, but have not been treated on the same grounds. This could have been addressed in the MiFIR review to avoid differences in legal interpretations. Secondly, ESMA could also have been given more powers to define requirements in certain areas based on further assessments e.g. of the liquidity of instruments or of the size of transactions. ESMA has a significant amount of data that could be used to perform those assessments. Finally, transactions in sovereign bonds could have been approached differently. This is normally a liquid asset class, but certain differentiations could be made in the deferral requirements to cater for national-specific contingencies.

2. Issues to consider in the establishment and implementation of the MiFIR review framework

An official stated that the MiFIR review measures generally align with the broader ambition of increased transparency and simplification in the capital markets. Price discovery and the role played by stock markets is essential, not only in the context of trading, but also for the broader economy and as a public good. This is reflected in the OECD corporate governance principles, which were recently updated and endorsed by the G20. A clarification that has been made on the occasion of the update of these principles is that all investors are expected to contribute to price discovery, regardless of investment strategy.

However, price discovery is sometimes challenging in the EU context, because there are 27 countries and a large degree of fragmentation in the market. There are more than 500 trading venues in the EEA, of which almost 200 SIs. That makes improving comparability essential. The consolidated tape (CT) is the most important measure that has been agreed in this regard.

In order to ensure a successful implementation of the MiFIR review proposal, three aspects should be considered. First, any significant change to market structure or functioning will run up against competing interests. A thorough and objective assessment of the likely impacts is therefore needed. This was seen with the implementation of TRACE in the US 20 years ago which led to a great deal of discussion about the effect that transparency would have on bond market liquidity. The rules were phased in over several years, and the consensus in the end was that the impact on liquidity had been neutral at worst.

Secondly, when waivers are being considered, which can be legitimate, they should have a clear rationale against which they can be evaluated. For example, waivers limiting pre-trade transparency aim to reduce the market impact of large orders. In that context, the rationale for lit trading waivers for small trades seems limited. Research shows that small trades are in fact being executed in the dark, which goes against the objective of enhancing transparency and price formation. This has been observed in OECD research on the US market, where there is no difference in the average trade size between dark and lit orders. Data on the French market also shows that the median size traded on SIs in French blue-chip stocks is smaller than the average Euronext trade. SI trading is between 15% to 20% of all trading in France, of which less than a quarter is subject to pre trade transparency.

Thirdly, rules have to be adapted to the market in which they apply. Before MiFID II was implemented in the Swedish corporate bond market a national rule required volume and price disclosure by 09.00 am at the latest on the day after the trade. On the face of it, MiFID II was much more stringent and mandated near real time disclosure, but because of the waivers for non-liquid bonds, the actual effect was a reduction in transparency. An impact assessment of this measure conducted by the Swedish FSA in 2019 showed that only one Swedish ISIN bond was considered liquid; if the entire market is an exception, the regulation is not fit for the market where it applies.

3. Competitiveness issues associated with the MiFIR review

The Chair noted that in a recent op-ed published in the Financial Times by the German and French Ministers of Finance calling for closing the EU capital markets gap[1] it was suggested that competitiveness should no longer be a secondary objective. There is also a significant discussion in the UK about whether the mandate of regulators and / or supervisors should include competitiveness.

1. Bruno Le Maire and Christian Lindner : We must close the EU capital markets gap – Financial Times 13 September 2023 'we must make our market framework more agile and no longer treat competitiveness as a mere afterthought'

3.1 Impact of the MiFIR review in terms of international competitiveness and access to funding

An official considered that the MiFIR review proposals are moving in the right direction when it comes to competitiveness, but that significant work remains. When evaluating the impact of regulatory changes on EU capital market functioning, it is useful to consider two separate perspectives: international competitiveness and access to finance. This is effectively equivalent to dividing the discussion into the impact on large and small companies.

On the first point of international competitiveness, the objective is to attract foreign companies to list in the EU and to retain successful EU companies within the EU. From the perspective of a CFO of a large company, the aspects that determine where you decide to list are essentially: the prospective liquidity of your stock, the accuracy of the price, your cost of capital, and having access to capital when needed. The MiFIR review proposals are relevant to these topics, and should therefore help improve competitiveness to an extent. However, the primary issue with EU capital markets is not trading, which is downstream from capital market development more broadly. Instead, the most important issue is one of scale: the EU needs more institutional investor capital, notably pension funds, in the equity markets. The proposal will not address this issue, meaning we should expect improvements mostly at the margin.

In terms of access to finance for smaller companies, trading rules are likely to have less impact. This is because trading is concentrated in large companies[2]. In addition, OECD research shows that in every major market around the world the average institutional investor stake is significantly higher in larger companies than in smaller companies. For smaller companies, retail investors are instead an important investor group, meaning that improving the access to finance for SMEs requires attracting retail investment to the market[3]. Pre-trade transparency is less useful as a tool in this respect. Instead, measures related to financial education, fiscal incentives and a functioning framework for qualified retail investors, as well as measures to encourage ease of use of trading platforms are needed. Another aspect to focus on are the prelisting conditions, and whether there is a vibrant venture capital (VC) market and a well-functioning funding ladder from private funding to public listing to support companies in their different stages of development. Those aspects are also partly covered in the Listing Act proposal.

An industry representative emphasised the importance of ensuring the competitiveness of European market participants compared to their competitors outside the EU. A competitiveness check should be systematically performed when new regulations are proposed to evaluate their impact on the competitiveness of EU capital markets and players. Absent such test, we find ourselves correcting ill-calibrated rules several years after they have been implemented and have damaged the competitiveness of EU market participants. This is typically the case with the application of the DTO to situations where EU entities trade with non-EU clients, that was implemented with MiFIR and will only be corrected when the provision in the MiFIR review for the targeted suspension of the DTO is applied.

Another industry representative pointed out that the objective of increasing competition and competitiveness in the market may lead to further fragmentation which may go against the objective of increasing transparency in the market and improving price formation, unless more volume can be driven to lit markets. Those effects also need to be taken into account.

3.2 Flexibility and capacity to react to market evolutions

The Chair noted that a key element of competitiveness is flexibility and the capacity for regulators and supervisors to adapt rules to the fast pace of change that is seen in markets. The UK has empowered the Financial Conduct Authority (FCA) to take significant decisions on how much dark trading there should be, but the EU tends to tackle this via the legislation. This requires having sufficient flexibility and agility in the EU rule-making system to adapt rules to the market changes, but this still needs improving in the EU. In recent years there has been the need to suspend the DTO on some occasions, but the process takes months. By the time the suspension is effective, the market may have changed course. Markets are complex and evolve quickly, meaning that everything cannot be pre programmed in a Level 1 instrument that is reviewed every 10 years; solutions need to be found to adapt the requirements while preserving legal certainty.

A regulator stated that the adjustments being made in the MiFIR review as a result of Brexit and market evolutions should contribute to building a European capital market that can compete more effectively with other large trading blocks, including the UK, the US and Asia. That should result in a larger, more integrated, liquid, and transparent European capital market. To remain competitive in the future, it would however be beneficial to make most of those regulatory changes at Level 2 and give a broader mandate to ESMA to change specific rules, in order to speed up the policy cycle.

Another regulator agreed that more measures should be defined at Level 2 than Level 1 to allow flexibility. The market is still in a post-Brexit context and the wholesale market review (WMR) is being examined in the UK. The outcome of the WMR for the trading obligations for shares and derivatives is different to the MiFIR review, as the UK has decided to abolish some requirements that the EU introduced, which may have significant competitive impacts on the EU. Sufficient flexibility to adapt the rules to changing market and competitive conditions is essential in a context where UK regulators have more freedom to adjust rules, possibly necessitating a push towards Level 2. The EU

2. On Euronext Paris the largest 20 companies represent more than 60% of total turnover. In Amsterdam it is over 80%. It is the same in the US, Japan and everywhere else. The largest 10% of market cap is between 70% and 90% of trading.

3. For example on First North, the Nordic growth market, more than 50% of all trading is retail driven.

institutional setup may also need reconsidering to speed up rulemaking and amendments.

An industry representative considered that speeding up the EU legislative process will be difficult. With this in mind, care must be taken in particular to not encapsulate measures with fixed levels in the Level 1 text that will take many years to change, particularly in a context where the UK is making sure that the process to amend its regulation is as quick as possible, which will require rules to be adapted for the EU to remain competitive. Unfortunately, some measures of the MiFIR review concerning transparency for bonds for example have some fixed levels set in Level 1. That should be left to the Level 2.

Another industry speaker agreed that the capacity of reaction is vital, as regulation is usually significantly behind the markets. Regulation must move faster and help to reduce fragmentation in a context of divergence with other jurisdictions.