Unravelling Ariadne's MiFID II Thread:
Pre- and post-trade transparency for non-equity markets

6 April, 13:00-15:45 | Place du Congres 1, 1000-Brussels

SUMMARY

Pre- and post-trade transparency requirements under MiFID II are expected to cause a big bang effect in non-equity markets, especially for bonds and derivatives markets. As underlined in the discussions among the participants at a half-day conference organised by ECMI on April 6th, much more remains to be done between now and January 2018. While a higher level of transparency is of great importance, its effect on liquidity is expected to be negative for a number of reasons. The lack of clarity surrounding the Systematic Internaliser (SI) regime – the process followed by firms that aspire to become an SI – and the liquidity thresholds pose many questions that need to be urgently addressed. The trading obligation requirements, according to which only the most standardised liquid derivatives will be traded on a trading venue, is of primary significance. It is essential for ESMA (European Securities and Markets Authority) to get these requirements right in order to avoid misinterpretations. Moreover, greater attention and precision should be given to best execution, particularly to the questions of when and under whose rules – EU rules, venues rules or overseas rules – execution occurs. Although time is running out, solutions can be found, which hopefully will not be too detrimental to the market. The phase-in approach will certainly help and allow regulators to carefully monitor the implementation of the new requirements and make adjustments or improvements where necessary.

13:00 MiFID II and transparency – Impact on bond markets

While both trading venues and systematic internalisers need to publish quotes and trades, thought also needs to be given to how this new transparency will change market behaviours and how the new data can be used. Bond trading is mostly conducted over the counter and so far has relied on banks acting as dealers, maintaining an inventory of bonds to trade bilaterally with investors. Investors have therefore come to rely on dealers for immediacy. But the market structure is also partly a function of the lack of information about prices and market conditions faced by investors. This is a key issue that MiFID II seeks to address via a pre- and post-trade transparency framework for all non-equity financial instruments.

- How will the new rules be implemented, and how will they impact market structure? Will greater transparency undermine liquidity?
- How will the calibration of transparency requirements for different types of trading systems work?
- Can we achieve operational simplicity and accuracy at the same time? How can consistent applications across all jurisdictions be ensured?
- Will the buy-side enjoy the same support and liquidity under the SI regime as they do with BCNs?

Speakers:
Jorge Yzaguirre Scharfhausen, Director of Markets, Bolsas y Mercados Españoles
Bas Dommerholt, Supervision Officer, Capital Markets, Netherlands Authority for the Financial Markets
Julian Allen-Ellis, Director MiFID, Association for Financial Markets in Europe
Per Loven, Commercial Director, Boat Services, TRADEcho

Moderator **Karel Lannoo**, CEO, CEPS and General Manager, ECMI

Note: This report was drafted by Dr Apostolos Thomadakis (Researcher, European Capital Markets Institute). This event report is not a transcript of the speakers' interventions; rather it should be understood as an interpretation of their views by the author.

Jorge Yzaguirre Scharfhausen presented the preparations put in place by Bolsas y Mercados Españoles (BME) to comply with the pre- and post-trade transparency requirements and illustrated the current trading models available on the Spanish fixed income market (AIAF, SEND, EXCHANGES, SENAF and MARF). The new transparency requirements are expected to affect approximately 50% of the private fixed income operations, 50% of the public debt operations carried out between entities and practically all of the public debt operations with third parties. Mr Yzaguirre Scharfhausen explained that only 2% of the number of currently traded ISIN products are classified as liquid, while 98% are considered illiquid. These liquid products however represent approximately 90% of the total traded volume. With respect to the systematic internaliser (SI) regime, BME will need to acquire all trades and volume of its trading members, in order to avoid the inclusion of trading members in this regime. After that, trades with a size above large-in-scale (LIS), as well as trades below a size specific to instrument (SSTI) will go through an electronic order book (EOB). On the other hand, trades below LIS and above SSTI will be routed to a request for quote (RFQ) platform. Finally, BME is planning to extend its offering, to include European sovereign and corporate bonds, and to target bonds of Spanish companies listed on other exchanges in particular.

Bas Dommerholt started by raising the issue of bond market liquidity and the fact that a lot of market participants experience reduced liquidity, as well as the difficulty that regulators have in measuring it. He proposed that more economies of scale are needed in the trading of bonds; in the sense that liquidity providers have access to more clients. The role of transparency in achieving those economies of scale is crucial, as it will facilitate the creation and development of modern technology that will enable better connections between clients and liquidity providers. He highlighted the importance of SIs and their role in moving the bond market in the direction of other markets, such as the equity market, which is better developed and more standardised. Mr Dommerholt expressed optimism about the outcome of this process. Transparency can and is expected to make the market more disintermediated and accessible, especially to non-professional investors. However, the complexity of the regulation and the fact that many aspects are not yet clear may impose obstacles. Finally, he commented that the phase-in approach is of great importance as it will allow regulators to carefully monitor the implementation of the new requirements and to make adjustments or improvements where necessary.

While Julian Allen-Ellis highlighted the importance of increased transparency in bond markets in his presentation, he also questioned whether transparency will be accompanied by an increase in liquidity. MiFID II is expected to bring a vast amount of technological, operational and personnel changes. Only large players will be able to accommodate these changes, while small and medium-size players will struggle. In addition, there is a lot of confusion surrounding the process by which firms can become SIs and their need to follow liquidity thresholds or opt-in on a voluntary basis. Several questions need to be urgently addressed, including: i) On which basis will firms assess themselves? ii) What administrative requirements must be met? iii) How long will it take to opt-in? iv) What process should be followed when a firm falls out or opts-out of the liquidity regime? and v) Can firms become SIs in all instruments or just a few? Another point of concern is the lack of SIs' GoldenSource. Even though ESMA (through NCAs) will collate data on who is and who is not an SI in individual instruments, it will not produce a machine-readable GoldenSource at instrument level, due to financial constraints. This approach is not sufficiently rigorous to determine which firms must submit pre- and post-trade reporting. Finally, Mr Allen-Ellis was worried that 97% of corporate bonds will be deemed illiquid and that NCAs will subsequently decide on the deferral period. While the retail market may opt for a shorter deferral period (two days), the institutional market may go for a more extended deferral period (four weeks). This is due to ESMA's lack of harmonisation and standardisation on the deferral period across the entire regime.

The key differences between fixed income markets and equity markets (OTC versus on-venue, credit-driven versus order-driven, participants are price-takers rather than price-makers) highlighted by Per Loven, who also commented that the changes MiFID II will bring to the fixed income markets will be much more dramatic than those MiFID I brought to the equity markets. Transparency is necessary, and it is expected to change some of these differences, but transparency just for the sake of transparency itself does not necessarily bring any gains. Furthermore, while it may be appealing to talk about the retail investor, especially from a political point of view, the focus should rather be on the end-investor (institutional investor). While the price is important for the retail investor, from the institutional point of view, depth to liquidity is more important than pricing. Mr Loven argued that the level of transparency imposed by regulators on the fixed income market is quite high, but he expressed his concerns that higher transparency will undermine liquidity for three main reasons: i) the cost of capital in the banks' inventory has increased massively since the financial crisis; ii) the multiple of issues (equity securities and bonds) make the market less concentrated and less liquid; and iii) the equity market is a very heavily traded secondary market (buy-and-hold). Finally, greater transparency will definitely provide a better understanding of the market and it will probably bring new entrants into the market.

14:30 MiFID II and transparency – Impact on derivatives markets

MiFID II requires certain standardized derivative contracts to be traded through a trading venue. However, this obligation only applies to those classes of derivatives that are cleared through a central counterparty (CCP) and that also are sufficiently liquid. ESMA will be responsible for assessing whether classes of derivatives should be subject to the trading obligation. However, the trading obligation gives rise to several major cross-border issues, including a requirement for some derivatives with non-EU elements to be trading on EU trading venues.

- How transparency reporting is going to work under MiFID II? What will be the impact on listed and cleared derivatives?
- Will OTC derivatives market, as a result of OTF's reporting requirements, be disrupted?
- How the new clearing rules will impact small and large buy side houses? What are the recovery rules for CCPs and what are the potential consequences for the buy side?
- Will additional collateral costs make the OTC derivatives business model significantly less attractive and less-well used by the buy side? Could the increased costs from the new transparency requirements prompt a move towards exchange-traded derivatives?

Speakers:
James Roberts, Director, European Public Policy, International Swaps and Derivatives Association
Alex McDonald, CEO, Wholesale Markets Brokers' Association
Tom Springbett, Manager, Trading and Post-Trade Policy, Financial Conduct Authority
Uwe Hillnhütter, Director, MiFID II Implementation, Tradeweb

Moderator **Karel Lannoo**, CEO, CEPS and General Manager, ECMI

The concept of liquidity in derivatives markets, according to **James Roberts,** is subjective. While there is an objective level of liquidity in the market (indicated by a certain level of trading and a certain number of distinct counterparties who serve products), it is very hard to see what is liquid from the practitioner's perspective in the absence of data. Therefore, distinguishing a liquid product from an illiquid one is important to get right. Additionally, further clarity is needed on what trading on a trading venue (TOTV) means. Regarding packaged trades, ESMA consulted on a proposal which would have considered a large number of illiquid package trades to be liquid for the purpose of MiFIR, but ESMA has since published a final proposal that is far more targeted and appropriate. Finally, one of the major outstanding pieces of commitment from the G20 Pittsburgh 2009 agreement was the trading obligation, according to which the most standardised liquid derivatives should be traded on a trading venue. Mr Roberts argued that it is very important for both Europe and

ESMA to get this right in order to avoid misinterpretations regarding trading obligation requirements. It is important to avoid the risk of excluding smaller players by increasing the cost of trading. While TOTV did not feature at Level 1, nor in the RTS (regulatory technical standards) debate, it suddenly became a big issue in Level 3, as pointed out by **Alex McDonald**. This is closely related to the definition of an instrument. Should an instrument be defined by RTS 23 or by RTS 2? While the former will require details to be reported as financial instrument reference data, the latter will require details of the asset class to be reported as a financial instrument transparency classification. RTS 23 is expected to create millions of instruments and ISINs, and therefore to weaken transparency. Moreover, more clarity is needed regarding execution, particularly concerning: i) when execution occurs, ii) under whose rules (EU rules, venues rules or overseas rules), and iii) whether the execution occurs in the same venue as where the arrangement is being done. Finally, on venue obligations and clearing, Mr McDonald argued that RTS 26 is based on the fragmentary idea of certainty of clearing. Instead, he proposed the idea that self-clearers should be exempt, which implies that the venue has the obligation to 'provide a facility' for checking but is not actually obliged to check each order itself (pre-trade checking).

Tom Springbett started his presentation by highlighting the rapid innovation and creativity observed in early 2000s, which allowed the derivatives market to grow very rapidly. While it is the regulators' job to support innovation and ensure that it doesn't create undue risks, the financial crisis imposed many challenges on that part of that job. The acknowledgement from the G20, that the counterparty credit risk management in OTC derivatives markets has been inconsistent, leading to the use of CCPs (or bilateral collateral arrangements) and to the insistence that standardised OTC derivatives should be traded on electronic venues. Furthermore, Mr Springbett stressed the importance and advantages of MiFID II for the markets. The move towards more standardised and more transparent markets will help end-users to make better decisions regarding their investments, as well as provide better access to liquidity. However, the potential downside effects should not be ignored. There is a risk of making the access to derivatives markets more challenging and complicated, particularly for small players.

On the buy-side, **Uwe Hillnhütter** expressed concern that what MiFID II aims to achieve in the transparency regime may jeopardise the provision of liquidity or the provision of balance sheet. At the same time, however, it should be recognised that both regulators and ESMA have gone through a very long process of calibrating the liquidity and transparency regime in a mindful way. The transitional transparency calculations by ESMA, in particular the definition of liquid versus illiquid instruments and the four thresholds (pre- and post-trade SSTIs and LIs), consist of tasks that require the production of a lot of data for which there currently is no good source. Whether this will lead to less liquid instruments and/or lower thresholds remains to be seen. Finally, Mr Hillnhütter urged a solution regarding: i) the uncertainty on the pre- and post-trade transparency reporting obligations on listed derivatives, ii) the delay in the SI regime, which may have a slightly negative impact on best execution requirements, and iii) the provision of transaction reporting by non-European participants who currently trade on European trading venues. Even though the time is running out, hopefully solutions can be found that will not be too detrimental to the markets.

*This event is part of a series of special events that ECMI organises on the topic of **Getting ready for the implementation of MiFID II/MiFIR** to discuss the readiness of market players and the supervisory community to comply with the provisions set out in new legislative framework. Two further panel debates will be held on "Data publication arrangements, consolidation and reporting" (**June**) and "Investor protection provisions" (**September**).*

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LIST OF ATTENDEES

Cosmina Amariei, Researcher, CEPS
Sandra Andersson, Junior Policy Assistant, Federation of European Securities Exchanges
Apostolos Aravanis, PO, European Commission
Paul Baes, Former Council EU, EU
Gabriel Callsen, Associate, International Capital Market Association (ICMA)
David Clark, Executive Director, TIGFI
Stéphanie David, Student Specialised in EU Law, Aix-Marseille Université
Willem Pieter De Groen, Research Fellow, CEPS
Godfried De Vidts, Director of European Affairs, NEX
Angelos Delivorias, Policy Analyst, European Parliament
Nikolaos Despotou, Capital Markets Policy Intern, CFA Institute
Nicolas Dorgeret, Administrator, European Parliament
Betsy Dorudi, Senior Regulatory Strategy Analyst, London Stock Exchange Group
Guido Faltoni, Economist, European Central Bank
Michael Feuerstein, Associate, Brunswick Group
Elin Fredriksson, Consultant, Afore Consulting
Julia Freese, Intern, Representation of the State of Hessen to the EU
Elena Gaetini, Head of Business Development and Government Affairs, RegTek Solutions
Kurt Gaissert, Advisor, Association of German SMEs
Annalaura Gallo, Project Consultant, APCO Worldwide
Elvira Grassi, Programme Manager, European Commission
Panos Gredis, EPLO Representative in Brussels, European Puplic Law Organization (EPLO)
Jan Haizmann, Director, EFET
Federico Infelise, Regulatory Analyst, Intesa Sanpaolo
Maria Karampelia, Associate Director, KREAB
Olga Kletsky, Editor-in-Chief, Picking Alpha
Monika Kokstaite, PhD Researcher, IMT LUCCA
Robert Kopitsch, Associate Consultant, APCO Worldwide
Maarja Kuusik, Administrative Assistant – Economy and Finance, CEPS
Marie T. Lubs, Freelance Journalist, ARPNS
Maximilian Lueck, Head of EU Regulatory Affairs, Deutsches Aktieninstitut
Philipp Meyer, Guest Researcher, German Institute for International and Security Affairs
Andrea Mogni, Senior Financial Expert, GlobalGovernance Institute

Rémy Moura, Senior Adviser Capital Markets, European Savings and Retail Banks Group
Nikolay Nikolov, Stagiaire, European Commission
Jennifer Nille, Journalist, L'Echo
Gundars Ostrovskis, Senior Economist, European Commission
Mario Parrot, Member of the Political Secretariat, European Commission
Maja Petersen, Assistant, Danish Permanent Representation to the EU
Flora Petrucci, Market Research Manager, Euroclear
Simon Pettinger, Policy Advisor, European Banking Federation
Natalie Pettinger Kearney, Deputy Head, EU Affairs, Freshfields Bruckhaus Deringer
Conrad Rein, Policy Officer, European Commission
Bettina Schmid, Stagiaire, Raiffeisen Bank International AG
Stefano Spinaci, Financial Administrator, European Parliament
Cristina Sucila, Case Handler, European Commission
Maria Tejero, Correspondent, El Confidencial
Apostolos Thomadakis, Researcher, CEPS
Annarita Tonet, Financial Services and Company Law Attaché, Perm. Rep. of Italy to the EU
Victor Van Hoorn, Account Director, Hume Brophy
Geert Vanderbeke, Executive Director, ABN AMRO Clearing
Guylaine Vandooren, Associate Director, FleishmanHillard
Georgios Vassalos, PhD Researcher, Strasbourg University
Walter Verbeke, Director, Euroclear SA
Matilda Wallmon, Senior Consultant, FTI Consulting
Andreas Walstad, Editor, EU Policy, Interfax Global Energy
Tom Weingärtner, European Correspondent, E&M powernews
Lucie Xia, Doctoral Researcher, University of Oxford
Fujing Ye, Economic Counsellor, Chinese Mission to the EU

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