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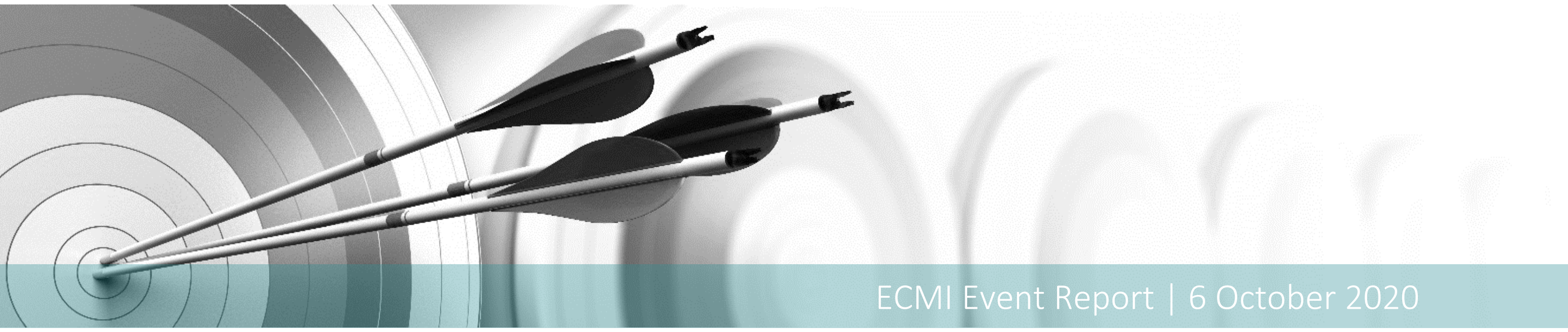

Opening the MiFID II Pandora's box

Karel Lannoo and Apostolos Thomadakis*

Earlier this year, the Commission started consulting on a series of priority areas as part of its ongoing MIFID II/MiFIR review. This ECMI webinar focused on two issues that are rather technical (and perhaps controversial) but are nonetheless key to the functioning of capital markets. These issues are investment research and the non-equity transparency regime. 'Re-bundling' will be allowed for small/mid-cap issuers and fixed income, as a response to criticism that unbundling reduced research coverage – even if the evidence is far from conclusive on this matter. MiFID II expanded the scope of the pre-and post-trade transparency to the fixed income space. However, there are concerns that the objectives have not yet been met, especially given the specific market structure. Proposals to simplify and improve the overall conditions for participants include liquidity thresholds, waivers and deferral options, for example.

Speakers:

Tilman Lueder, Head of the Securities Market Unit, DG FISMA, European Commission

Liz Callaghan, Director, Secondary Markets - Market Practice and Regulatory Policy, ICMA

Pierre Chabrol, Head of the Savings and Financial Market Unit, French Treasury

Matthijs Geneste, Supervisor Market Infrastructure, Capital Markets Integrity, Dutch Authority for the Financial Markets (AFM)

The report is not a transcript of the speakers' interventions; rather, it should be understood as an interpretation of their views by the author.

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Summary

The European Commission is proposing certain targeted amendments to MiFID II now, as part of a broader review that is expected next year. These proposals form part of the reaction to the Covid-19 crisis, and include some uncontroversial draft amendments regarding wholesale markets, namely energy and commodity markets, and position limits. The controversial elements concern the retail markets, the issue of corporate bonds, and the investment research of SMEs or midcaps. Controversy also surrounds a second set of amendments that are expected in the 2nd quarter of 2021 and will affect MiFIR, which some would already like to have as part of the current package. The holistic review of MiFID, expected later, should also cover certain retail investor issues.

As regards derivatives markets, the EU Commission is now proposing a series of amendments on energy derivatives, with a recalibration of the position limit regime and the scope of the hedging exception. On information requirements, there are fewer mandatory disclosures. Information provided to clients, in particular professional clients such as large corporates and financial institutions, will now be more targeted to their needs. At the retail level, the requirement to publish the best execution report is proposed to be suspended, and certain corporate bonds should be more accessible to retail clients by lifting product governance requirements.

As far as investment research is concerned, the EU Commission is proposing to allow some re-bundling to support investment research for small and mid-cap companies up to the €1 bn market cap threshold, as an option in amendments to a Delegated Directive (EU 2017/593). The Commission believes that coverage by analysts of this group is low although it is not sure whether this is related to bundling. Unbundling was initially proposed to tackle inducements in asset management, for example issuer-sponsored research, and to provide more transparency to investors. The amendments also cover the fixed income sector, although there was never bundling in the execution, or a research component in the spread.[1] For the fixed income sector, research is not part of the execution costs; it is generally commissioned separately.

The Commission argues that the intended impact of opening up the research market to independent research providers has not been achieved. The rebundling (optional) exemption is not about allowing big asset managers and top tier investment banks to have a dual system. But it rather targets the relationship between brokers and asset managers specialised in small/mid-cap issuers. In many member states the post-Brexit reality is that the local asset manager will focus on this segment (i.e. small and mid-cap), while the local broker will execute trades.

The transparency requirements of the fixed income market are also different from equity markets requirements, and depend on the sizes – large in scale (LIS) compared to normal market size and the size specific to the instrument (SSTI) classifications set by ESMA. Thus, proposals made to remove/delete the SSTI-waiver (in particular the post-trade SSTI), will not only result in less transparency, but will also create 'false positives' or misclassified bonds.[2] So far, not many bonds are

[1] Fixed income is a dealer market, not an agency market. This means that the dealer closes the spread and the investor (e.g. asset manager) submits a Request for Quote (RFQ). If research is bundled into the quote, this could result in losing the deal (as the quote will be too high). So, if there is no bundling in the first place, there is no inducement.

[2] A false positive would mean wider spreads, or that dealers are not prepared to deal as they cannot trade out of the position.

considered to be liquid, but lowering the liquidity assessment will reduce the number of bonds in the assessment. This is because it lowers the post-trade reports and reduces transparency in the bond markets in i.e. the high yield or other special segments such as the Danish mortgage bond market, according to the ICMA. This was certainly not the original aim of MiFID II, which is aiming to have a consolidated tape for the different market segments.

The best transparency regime or liquidity assessment regime is one that works in practice. And the one that we have today is over-engineered and complex. Finding the right balance between transparency and liquidity requires a more fundamental look at the structure of the primary market, the role and desires of issuers when issuing debt instruments, the role of intermediaries, and the fungibility of instruments that could lead to more natural forms of liquidity. For example, the importance of having a more credit-rating liquidity assessment methodology backed up by verifiable datasets, is desirable.[3] A much simpler and more trustworthy liquidity assessment regime will not only benefit market participants but make ESMA's work in implementing it a lot easier.

In its reading, the European Parliament's rapporteur proposed increasing the threshold of unbundling to €10bn (meaning that it will extend the unbundling exemption scope beyond SMEs, including some of the larger corporates), and proposed bringing the delegated act as a level 1 element of MiFID, meaning that future changes will become more cumbersome. Member states' views on partial re-bundling are diverse; some, such as the webinar representative from France's Ministry of Finance, support it, while the Dutch are against. The Dutch market supervisor, AFM, believed that the decline in research is not only the result of MiFID II rules; that it is premature to allow for further exemptions on unbundling; and that a full review is needed (based on a deep and diligent evaluation of the rules, which were enforced just three years ago). There is no need to draw conclusions too early and to start re-bundling, also for fixed income markets. The French Ministry of Finance, on the other hand, believes that unbundling has negative consequences for financial research on mid-caps, and that the threshold should well exceed the current level.[4]

If the aim is to maintain the MiFID II idea of limiting the bundling of execution and research, and not to jeopardise the ecosystem of financial research companies, it is crucial to foster sponsored research on small caps. Ensuring the production of financial research that is accessible to SMEs requires a new legal framework for sponsored research. However, this should come in the level 1 text.

Overall, the need to stimulate and re-equitise SME markets was a shared concern, as well as the need to reduce the over-dependence on debt financing. The full MiFID review should have clear objectives and be proportional, with sufficient scope for quick adaptation depending on the circumstances, as the Covid crisis has highlighted. It should also have a clear focus on retail investors. At the same time, the outcome of the reviewing process should not be a return to a pre-MiFID II situation. Once the Pandora's box is open, it may be difficult to close.

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[3] Perhaps establishing a data Advisory Group consisting of industry representatives, data scientists and data engineers – like the one suggested by ESMA but never launched – may be a good starting point.

[4] Some member states have argued that this threshold seems to have been determined quite arbitrarily. Thus, having a negative impact on ensuring a level playing field between issuers with similar corporate profiles that are slightly above that threshold.

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