Review of the MiFID II/MiFIR regulatory framework

Brussels, 18th May 2020

Executive Summary

FESE very much welcomes the opportunity to respond to the public consultation on the review of MiFID II/MiFIR regulatory framework. This review comes at the right moment particularly as, soon after the consultation was launched, the EU faced additional challenges due to the COVID-19 outbreak. Whilst the health and economic situation is a matter of concern for all, it does provide the occasion for both market participants and policy makers to truly assess what needs to be done to **support the economy in its recovery**, and to adjust measures in place that should work better to **fulfil the original intentions of MiFID**.

The lessons learnt should provide the basis for reviewing all existing and new measures.

During this crisis, central banks and governments have reacted swiftly to inject liquidity, but ultimately when solvency is lacking, the transformational capacity of banks can only work to a certain extent. **Equity is needed to buffer exogenous shocks** and will be needed more than ever so that public equity capital markets can perform to the best of their abilities in helping businesses weather the crisis and refinance their growth once the situation has subsided.

Financial infrastructures have performed well and demonstrated resilience. Periods of crisis demonstrate that, **at times of high uncertainty, more trading volumes go to the Regulated Market (as a safe, transparent and robust trading venue where core price formation takes place)**, instead of through a bank or anonymous execution venues. These periods have also demonstrated that **transparency is highly appreciated by all market participants**, as it offers financial stability, integrity and fairness.

While MiFID I introduced more competition in equity markets, **MiFID II was meant to strengthen the price formation process by increasing transparency** and ensuring that all market participants, carrying out the same activity, would be regulated in the same way. This was important not only to ensure fair competition but also for investor protection, legal clarity and market integrity.

However, **MiFID II has enabled the growth in off-trading and has unintendedly facilitated a proliferation of Systematic Internalisers (SIs)** to the detriment of the price formation process. This increased market fragmentation further diminished transparency.

As a result, the share of price forming lit trading activity has decreased disadvantaging issuers and investors.

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Fair Competition & Market Structure
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Conclusion
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It is crucial that the design of equity market structure takes priority. FESE proposes a **simplified market structure concept** designed to strengthen lit markets where the large-in-scale (LIS) threshold is used as the main tool to delineate lit and dark trading. FESE believes that restricting SI equity trading to above LIS only would be an efficient way to incentivise lit trading, ensure the quality and robustness of price formation, in line with the initial objective of MiFID II. There would no longer be a need for a double volume cap mechanism in this scenario since pre-trade transparency waivers would be limited to the LIS and order management facility (OMF) waivers.

Guaranteeing **high quality, reliable and consistent flagging of SI and OTC trades** is key to delivering a consolidated tape (CT) that could be considered meaningful. FESE believes that a broader implementation of the **Market model Typology (MMT)**, which currently ensures consistency of exchange data, would contribute to addressing existing data quality issues.

Having a 100% view of the market – including SIs and OTC- is critical to ensuring that investors can assess execution quality in a comprehensive manner. A CT that would not provide for full coverage of all execution venues would be deprived of practical significance.

Consolidated Tape
A pre-condition for a reliable CT is an improvement of off-venue data quality, covering all execution venues.

Conclusion
The creation of a "Tape of Record" would represent a cost-effective solution, avoid latency issues and deliver clear value to the market and investors: notably, a means for them to analyse execution quality.

A convincing use case is particularly important to ensure that the tape does not add cost to the industry (i.e. infrastructure and maintenance costs) without any clear benefits. A **"Tape of Record" (TOR)** would be more appropriate and more likely to meet market participant's needs than an "as close to real-time" tape. A **TOR would be significantly less complex and less costly to set-up** and would provide a comprehensive overview of overall liquidity within the EU on an instrument level.

Regarding listing on public markets, it provides companies with a platform to raise funds and thereafter to be traded in the marketplace by investors. **One of the key activities of a stock exchange is to organise activity on primary markets, especially for SMEs**. This includes education, promotion, marketing of issuers and communication with banks. Through these activities Exchanges play a crucial role in bringing SMEs to public markets.

Certain provisions included in MiFID II/R have resulted in **unintended consequences and increased regulatory burden on issuers and investors.** In particular, MiFID II has accelerated the reduction in equity research focussing on smaller issuers. Pre-MiFID II, research was supplied as part of a bundled service, paid by execution fees. Research post-MiFID II is required to be unbundled and priced separately from trading venues. A growing number of SMEs are therefore paying independent **research providers** to write research and take the initiative in approaching investors directly. However, this is challenging due to potential conflict of interests and a lack of recognition and coverage limitations due to budget constraints. As a result of unbundling rules, fund managers are prevented from accepting research on small companies provided by brokers for free. The rules should be amended to allow brokers to send SME-research reports to fund managers without having to establish a research contract with them.

SMEs
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Conclusion
The rules should be amended to allow brokers to send SME-research reports to fund managers without having to establish a research contract with them. Authorising the bundling of SME research would be the fastest way to increase production and distribution of independent reports and may have the biggest effect on the liquidity of SMEs.

With respect to derivatives trading, capital markets with deep pools of liquidity across different market segments can act as a strong stabilising force in times of crisis by diversifying sources of finance. Even more so, the criticality of liquid and transparent markets becomes obvious on risk transfer markets which heavily rely on the **liquidity found in Exchange Traded Derivatives (ETDs)**. In critical market situations, liquidity in bilaterally traded products does not allow for efficient risk management. This is precisely the time when market participants turn to liquid and transparent markets – the **'flight to quality'** principle. Any fundamental and experimental market structure change (such as the MiFIR provisions on **'non-discriminatory' access for ETDs) should therefore not be implemented unless a quantitative financial stability impact is conducted** to carefully assess all possible negative effects on the financial stability and competitiveness of the EU27.

Derivatives
Applying 'non-discriminatory' access to exchange-traded derivatives is the wrong policy both within the Single Market, and for EU competitiveness and positioning in a global market. Choosing to implement such an experimental market structure reform during a period of economic and market crisis is also fundamentally unsound.

Conclusion:
The existing implementation deadline should be extended for at least another 30 months. This will ensure that precious resources and strained operational capacities are not diverted in the current situation and will allow the European Commission to run a proper impact assessment.

For **commodity derivatives**, we agree with the overall objective of MiFID II/MiFIR to 'improve the functioning and transparency of commodity markets and address excessive commodity price volatility', but we feel these objectives have not materialised with the implementation of the position limits and pre-trade transparency regimes. The MiFID II position limits regime has been able to function for a number of well-developed benchmark contracts. However, for the development of new and illiquid products and further growth of the existing non-benchmark liquid commodity derivative markets, the regime has proven to be a substantial barrier. To solve these issues, we would suggest a **fundamental review of the scope with the aim of moving towards a more proportionate and efficient position limit regime**. This can be achieved by focusing its application to 'critical' contracts only.

In addition, while we support the aim of the **pre-trade transparency regime**, we believe the current calibration hampers a substantial increase in commodity contracts traded on exchanges and cleared through CCPs, hence being subject to a sufficient level of security and transparency.

Commodity Derivatives
The current position limit and pre-trade transparency regimes fail to meet the objectives of MiFID II/R to increase transparency and address excessive price volatility in commodity markets. In particular, the position limits regime is a substantial barrier for the development of new and illiquid products and further growth of the existing non-benchmark liquid commodity derivative markets. The current calibration of the pre-trade transparency regime does not allow for an increase in commodity contracts traded on exchanges and cleared through CCPs, hence being subject to a sufficient level of security and transparency.

Conclusion
The scope of the position limits regime should focus its application to 'critical' contracts only. The pre-trade transparency regime should be better tailored to commodity markets, i.e. the hedging exemption should be extended to all market participants, including financial counterparties, and the methodology in RTS2 should be amended.

Additional issues raised in the response:

Availability and price of market data	FESE agrees with the German Finance Ministry in their MiFID II/R position paper of August 2019, which underlines that it should be assessed whether competition authorities, rather than financial supervisory authorities, are better suited for ensuring that pricing policies are set up on a "reasonable commercial basis". Nevertheless, FESE appreciates ESMA's recommendation to pursue the transparency plus model with some clarifications and harmonisations.
Share trading obligation	The share trading obligation (STO) remains necessary and is an important cornerstone of the overall aim of MiFID II/MiFIR to enhance the efficiency, resilience and integrity of financial markets in the EU. For the STO to be fully functional, further work on clearly determining which shares should be considered EU shares is necessary. The approach should avoid undue complexity and be based on predictable and meaningful criteria. FESE proposes to modify the STO regarding its third country dimension, scope, exemptions and application to asset classes. The full proposal is included in the response.
Midpoint	Midpoint orders are executed at the expense of participants willing to set or display a price. Ultimately, the idea that a midpoint price is fairer is flawed, as pegging can in some circumstances act similarly to a reference price without being subject to a waiver. FESE considers that for below LIS orders, midpoint pegging should not be allowed in central limit order books. However, midpoint pegging should be available for orders above LIS.
Reporting on best execution	FESE Members have dedicated enormous efforts and resources to the production and publication of RTS 27 reports. More than two years after the entry into force of MiFID II, best execution reports are published according to a methodology which has been defined in the past four to five years and covers format, calculations, publication frequency, storage. If the regulators were to amend in any way the regulation, we urge them to take into account the costs associated with any type of change - small or large - to those reports and to apply a reasonable approach which would take into account the ratio of costs/benefits of those reports and we would ask that investment firms and the trading venues are thoroughly consulted and given enough time to implement those changes.
The double volume cap	When assessing the DVC's capacity to limit dark trading, it is important that the benefits of such a mechanism are balanced against the high complexity of the DVC system. For this reason, FESE is calling to limit the available waivers under the transparency regime to the LIS and OMF waivers. In this case, the DVC mechanism would be rendered obsolete at the NT and the RP waivers would not exist anymore. The repeal of those waivers to mainly keep the LIS waiver is part of a broader simplified market structure where the LIS threshold is used as the main tool to delineate lit and dark trading. Because the main purpose of the waiver regime is to protect market participants from adverse market movements following the execution of large orders, there seems to be little justification

	for trading small orders via the RP or NT waivers, which is largely the case currently. Using the LIS threshold to delineate dark trading would be an efficient way to incentivise lit trading and address concerns about the impact of dark trading on financial markets and the price formation process all the while contributing to a much-needed simplification of the current framework. In addition, it makes sense to maintain the OMF waiver as an order in an OMF facility ultimately becomes pre-trade transparent and therefore contributes to the price formation process. However, it would still be important to allow for non-price forming technical trades to be reported off-book on exchange. FESE therefore calls for such a reporting tool to be defined at Level 1.
Non-equity: Level playing field between trading venues and SIs	We see an unlevel playing field between SIs and multilateral venues active in non-equity instruments. In particle, bonds and securitised derivatives trading is still opaque and there was no increase in transparency triggered by MiFID II compared to MiFID I. This is the case for SI trading where there is seemingly no pre- and post-trade transparency available. Therefore, for bonds and securitised derivatives, we would recommend using the €100,000 denomination threshold to delineate lit (RM, MTF and OTF) trading from dark (OTC and SI) trading. Prohibiting trades in instruments with denominations below €100,000 to be executed via SIs could trigger a shift of (retail) bond trading to lit venues compared to the current market structure where the major part of bond trades are executed in the dark. Trading at and below the €100,000 threshold on transparent multilateral venues would reduce market fragmentation and increase liquidity and pre- and post-trade transparency, in particular for retail investors. For securitised derivatives, this delimitation would simplify the fragmented execution landscape.
Digitalisation and new technologies	It is important to establish key principles upon which the EU can build a role in facilitating the development and implementation of FinTech. These principles include the need for: • The application of the same rules for the same services and risks (including across different pieces of legislation) based on the principle of technology neutrality; • A risk-based approach built on proportionality and materiality which allows for flexibility, particularly in respect of innovation with small groups of customers (i.e. sandboxes), while ensuring a level playing field across the EU; A balancing of the local (country) risks alongside the benefits of cross-border markets (i.e. scalability, interoperability and passporting of services).