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The state of implementation of MIFID II and preparing for Brexit

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Ladies and Gentlemen,

It is a real pleasure to be here in Athens today at the WFE Annual Meeting 2018 and to kick off the 2nd day of the conference.

As the Chair of ESMA it is not going to surprise you that in the first part of my speech I will focus on the current core project for European financial markets and therefore also for ESMA: MiFID II. While the start of MIFID II on 3 January is well behind us, the implementation and ongoing application of MIFID are as important as its preparations. MIFID II is obviously relevant for EU trading venues and, as I will explain shortly, in my view it is also important for trading venues outside the EU.

In the second part of my speech I will talk about the other topic which is currently a priority for ESMA: preparing for Brexit, and specifically in the areas of trading and central clearing. The UK and EU27 financial markets are highly integrated, and preparing for Brexit requires major efforts from all involved, trading venues, CCPs, national competent authorities (NCAs), and of course ESMA.

MIFID II and trading venues outside the EU

Conscious of the international audience here today, I believe that MiFID II should be of interest for non-EU trading venues, or third-country trading venues in EU jargon, because of MiFID II's impact outside the EU. MiFID II has already started triggering changes in EU market structure and the development of new trading modalities, and some of these changes may also be taken up outside Europe. Furthermore, other regulators will monitor developments under MiFID II and might be interested in the impact some of its more novel provisions may have.

Moreover, while the scope of MiFID II is focussed on the EU, there are various provisions that have an impact on third-country trading venues. For instance, EU market participants are no longer allowed to trade shares and derivatives subject to the MiFID II trading obligation on third-country trading venues without an equivalence decision by the European Commission.

What is MiFID II?

MiFID II is the main pillar of the EU's regulation of financial markets and aims at establishing a more transparent financial system that works for the benefit of the economy and society as a whole. While MiFID II covers a broad range, including for example the marketing, sales, and distribution of financial products to retail investors, I will focus today on the MiFID II provisions in the area of secondary markets.

MiFID II replaces the less comprehensive MiFID I framework that had been in place since 2007. In particular, MiFID II aims at improving market transparency and price formation, moving more transactions to regulated platforms, closing loopholes in the market structure framework and responds to the increasingly complex market reality driven by technological innovation like algorithmic trading.

It would be premature at this stage, after only applying the new framework for nine months, to deliver a fully-fledged assessment on whether MiFID II delivered on these ambitious objectives. Nevertheless, I believe that now is a good time to assess where MiFID II has actually delivered or is starting to deliver, and to identify areas where corrective action might be needed in the future.

MiFID II and transparency

MiFID II introduces an ambitious pre- and post-trade transparency regime applicable to all equity and non-equity instruments. This is a major change compared to MiFID I which only applied pre- and post-trade transparency to equities. Concerning pre-trade transparency, MiFID II requires trading venues and so-called systematic internalisers – i.e. firms that trade on their own account with clients on a systematic and substantial basis – to make public quotes in instruments they are trading. On post-trade transparency, transactions, regardless of whether they are executed on trading venues or OTC, have to be published in real-time. Finally, MiFID II introduces a trading obligation for shares, requiring investment firms to conclude transactions in shares either on an EU venue, an EU systematic internaliser, or a third-country trading venue following an equivalence decision of the European Commission.

Of course, MiFID II provides for the possibility for orders to have a waiver from pre-trade transparency and to defer post-trade transparency subject to certain conditions. In particular, and without going into too many details, one of the two following conditions has to be met in order to benefit from a waiver or deferral:

1) the order or transaction is of a large size; and

2) the order or transaction is in an instrument that does not have a liquid market.

The aspect of liquidity is particularly important for non-equity instruments.

To summarise, the MiFID II transparency regime is not about providing full transparency, but the right amount of transparency that contributes to efficient price formation and to a level-playing field between the different types of trading venues while avoiding adverse market impact. ESMA has been in charge of the calibration of the transparency regime, a complex exercise which took us several years to prepare.

ESMA continues playing a key role for the MiFID II transparency regime since we are in charge of periodically determining the liquidity status and applicable thresholds for waivers and deferrals. Following an agreement with EU NCAs, ESMA has developed a central facility in relation to instrument reference and trading data. This facility receives data from trading venues and approved publication arrangements (APAs), that report OTC-transactions from across the EU, either directly from these entities or from the NCAs, and performs all the calculations based on that data. We therefore provide a one-stop shop solution for all EU market participants and this avoided the costly development of similar systems in every single EU Member State.

It is probably easiest to explain how our system works based on an example. We perform the liquidity assessment for bonds on a quarterly basis, instrument by instrument. The outcome of this liquidity assessment determines whether bonds are subject to pre-trade transparency and real time post-trade transparency or not. The calculations are carried out on the basis of data received from trading venues and APAs covering the previous quarter. While the early days of operating this system have been challenging due to the large number of instruments covered and the necessity to collect complete data from venues and APAs for every single trading day, we have seen substantial improvements over time. On 1 August, which is our most recent update of bond market liquidity, we published the current liquidity determination for a grand total of 340,000 bonds.

A concern for ESMA is that only a small number of those bonds are currently passing the MiFID II liquidity test: 466. Improved data quality in the future may lead to somewhat higher figures and therefore more transparency. Equally, I should also manage expectations: even when all remaining data issues are addressed, the number of liquid bonds will be modest considering the clear political direction to have a cautious start of the bond transparency regime. As ESMA made clear when the regime was determined, we would have preferred a more ambitious start by bringing more bonds under the transparency regime.

Double Volume Cap

Another major innovation of MiFID II is the so-called double volume cap mechanism that applies to all equity instruments and is a truly unique and unprecedented feature of EU legislation. The objective of the double volume cap is to limit the execution of transactions in dark pools, i.e. on trading venues where trading interests interact <u>without</u> full pre-trade disclosure. The limit should preserve the quality of the price determination process on lit venues. The double volume cap tackles two types of transactions benefiting from a waiver:

(1) transactions that are executed in systems where the price is determined by reference to a price generated by another system – the so-called reference price waiver; and

(2) transactions that are bilaterally negotiated and formalised on a trading venue – the negotiated transaction waiver.

The double volume cap limits the transactions that can be executed under both those waivers at 4% at a trading venue level and at 8% for all EU trading venues. Once those thresholds are passed, trading venues are required to suspend dark trading for a 6 month period.

Since the application of MiFID II, the double volume cap mechanism resulted in the suspension of dark trading for more than 1200 instruments, mainly equities. We can already see the first impact of the double volume cap on market structure. From our observations, after more than six months of applying the caps, it appears that trading flow previously executed under one of the two waivers, is in particular flowing to systematic internalisers and periodic auction trading systems. Furthermore, we can observe an increase in block size transactions. The trend towards periodic auctions covers both traditional closing auctions as well as new periodic auction trading systems carrying out auctions continuously during the trading day, whereby each auction only lasts a few milliseconds. While the share of trading on those new periodic auction trading systems is still low, it can be seen that they are increasingly attracting trading flow.

These developments have attracted our attention and triggered concerns that some periodic auction systems may be designed with the intention to circumvent the double volume cap regime. Therefore, we have carried out a fact-finding exercise on periodic auction trading systems in recent months to fully understand their various features. We intend to publish, in the coming months, a call for evidence on this issue to gather further insights from stakeholders before concluding our analysis and considering whether further ESMA measures or recommendations are needed for those new types of trading systems.

Trading obligation derivatives

Let me now briefly move on to one area where MiFID II closely resembles legislation in other major economies. Back in 2009, the G20 leaders committed to move trading in standardised OTC derivatives to exchanges and electronic trading platforms. MiFID II translated this commitment into hard-coded law and the trading obligation for derivatives also started to apply in the EU on 3 January 2018. ESMA was in charge of determining the classes of OTC derivatives that should be subject to this trading obligation.

As a first step, we proposed to broadly align the scope of the trading obligation for derivatives in the EU to the scope of the trading obligation currently in place in the US. Therefore, the trading obligation currently covers the most common interest rate swaps denominated in Euros, Dollars and Sterling as well as some index CDS. We will continue monitoring the market and may propose in the future adjustments to the scope of classes of derivatives subject to the trading obligation.

MiFID II allows market participants to meet the trading obligation through trading on third-country trading venues following a Commission equivalence decision. The Commission has so far issued one equivalence decision covering designated contract markets (DCMs) and swap execution facilities (SEFs) in the US. Vice-versa, the Commodities and Futures Trading Commission (CFTC) exempted certain MTFs and OTFs from the requirement to register as SEFs so that US market participants can meet their trading obligation by trading on EU venues.

Market structure developments: systematic internalisers

MiFID II reinforces the regulatory regime for systematic internalisers to further level the playing field between them and trading venues. In particular, systematic internalisers are subject to pre-trade transparency requirements and organisational rules.

As previously mentioned, systematic internalisers appear to be enjoying a significant increase in market share under MiFID II. While it was one of the objectives of MiFID II to strengthen the internaliser regime and ensure that investment firms dealing with clients in an organised way are subject to transparency requirements and organisational rules, many concerns have been voiced about the playing field between internalisers and trading venues still not being level enough. In particular, there are concerns that the attractive environment for trading on systematic internalisers may ultimately result in changes in the market structure away from trading venues. For instance, systematic internalisers are currently not subject to the tick size regime applicable to trading venues in the EU for equity instruments meaning they can offer marginally better prices than trading venues.

ESMA, as an early corrective measure, in March this year submitted a proposal to the Commission to ensure that quotes of systematic internalisers which are subject to pre-trade transparency meet the tick size requirements. The Commission is now in the process of endorsing this proposal, albeit for a slightly narrower scope of instruments, thereby further aligning the regulatory requirements applicable to SIs and trading venues. We are hoping that this necessary amendment will make it into law very soon.

Brexit

Let me in the remainder of my speech focus on Brexit. As the UK plays an important role in EU financial markets, preparing for Brexit is one of ESMA’s main current priorities. The importance of the UK financial markets within the EU can be illustrated by looking at secondary markets where we estimate that about 40% of trading in equities issued in the EU27 currently takes place on UK trading venues.

In the context of Brexit preparations, I would like to mention three areas of work, emphasising that there are many links between the three work streams:

(1) ensuring the consistent application of regulatory and supervisory standards to the relocation of activities, entities and functions from the UK to the EU27;

(2) improving the third country arrangements in securities markets legislation in the context of Brexit; and

(3) preparing for the risk that, when the UK leaves by the end of March 2019, no agreement is in place regarding its withdrawal, or a no deal Brexit.

I will briefly comment on the first two work streams before focussing on the last one.

Relocation and consistent regulatory and supervisory standards

In order to prepare for Brexit a number of trading venues, similarly to asset managers and investment firms, are currently seeking authorisations in the EU27 to continue to access their financial markets. Such relocation of entities, activities and functions to the EU27 requires a common approach at EU level to safeguard investor protection, the orderly functioning of financial markets and financial stability.

ESMA issued four opinions last year providing for jointly agreed regulatory and supervisory standards to be met by the EU27 NCAs when dealing with relocations due to Brexit. One of the four opinions focuses on trading venues. The ESMA opinions stress that new authorisations must be granted in full compliance with Union law and in a coherent manner across the EU27. ESMA also set up a Supervisory Coordination Network where European supervisors can report on and discuss cases of relocating UK market participants and which, based on the last few months of experience, usefully contributes to promoting consistent decisions by NCAs.

Improving the third country arrangements in securities markets legislation

The prospect of a very large financial market moving out of the EU, while likely continuing to be very interconnected with the EU financial markets, has triggered a reconsideration of our third country arrangements. In that context, I welcome the increased responsibility entrusted to ESMA vis-à-vis third countries in the Commission’s legislative proposal under the ESAs’ review. However, although this is an important development, there remain other areas where we need improved third-country arrangements.

I would mention in particular the need for a comprehensive and harmonised EU regime for third-country trading venues. MiFID II leaves substantial national discretion with very diverse regimes currently in place. A harmonised third country regime would contribute to a level playing field between EU and non-EU trading venues and mitigate risks related to orderly markets, investor protection and ultimately stability. In my view, such regime should:

(1) cover all types of trading venues;

(2) cover in one equivalence decision all purposes for which they would need to be recognized (e.g., placing of trading screen, post-trade transparency, and trading obligations);

(3) ensure that third country trading venues accessing the EU comply with requirements that are equivalent to those for EU trading venues; and

(4) establish one point of entrance to the EU with effective supervisory tools.

Preparing for a no deal Brexit

While it is in the interest of both the EU27 and the UK to have a withdrawal agreement in place, we cannot rule out that the UK will leave in March 2019 without one. This would imply that UK market participants lose their authorisations to conduct business, or passports, across the EU. We all need to prepare for this potential no deal Brexit scenario. ESMA has in July this year reminded UK-based regulated entities, including trading venues, of the importance of timely submission of authorisation requests to be able to continue providing services in the EU27.

A no deal Brexit will not only result in UK market participants losing their passports for EU access, there will also be no legal basis anymore for the extensive and granular daily data exchange between the UK and the EU27 which takes place under MIFIDII. This data exchange goes far beyond the type of data exchange we typically have with third countries.

As explained in the first part of my speech, the MiFID II framework relies on a number of calculations to be performed at EU level, such as the double volume cap, the transparency regime for equity and non-equity instruments, including the liquidity assessment and the large scale or block size applicable to those instruments. Given the importance of the UK financial market within the EU, a no deal Brexit would affect those MIFID II calibrations and may trigger some significant effects.

ESMA is currently working to identify those effects that may arise from a no deal Brexit and to find the most efficient way to limit the impact for EU27 financial markets. While recognising that our respective financial markets will remain strongly interconnected, we need to avoid less effective regulation and supervision and a negative impact on the level playing field. We are considering all potential available tools to do so, including ESMA guidance and potential proposals for legislative amendments.

The amendment proposed by ESMA to the tick size methodology for shares is a good example of the initiatives ESMA can, and is taking, when there is a need to address level playing field issues arising between EU and third country trading venues and to ensure that an EU harmonised regime continues to prevail.

For those that are not familiar with the issue, I would quickly recall that in the first days of trading under MiFID II, and the new mandatory tick size regime, it became evident that the new regime, based on liquidity in the EU, did not work properly when applied to shares that have their main pool of liquidity outside of the EU. Because the tick size is based on EU liquidity only, the methodology can result in EU trading venues having to implement larger price increments than non-EU venues trading the same instrument, and thereby facing a drop in market share to the benefit of their non-EU counterparts. Based on the evidence reported, and beyond the urgent remedial actions taken by certain trading venues in coordination with their NCAs, ESMA issued a consultation paper suggesting different options for setting an appropriate tick size for instruments with their most liquid market outside the EU. To conclude on this, the start of the tick size regime earlier this year illustrates some of the issues we may be confronted with in the case of a no deal Brexit.

Let me now move to the area of central clearing of derivatives, which is generally considered to be the securities markets area to entail the highest stability risks in the event of no deal being reached.

The current legislative framework of EMIR does not allow ESMA to recognise CCPs based in the UK as third-country CCPs as long as it is an EU Member State. This legal obstacle results in a situation where EU Clearing Members, and EU trading venues, are uncertain about the continued access to EMIR-recognised CCPs. To respond to those risks to the stability of EU financial markets, in my view we need to ensure continued access to UK CCPs for EU clearing members and trading venues. Such continued access is in line with the EMIR 2.2 proposal which allows, under certain conditions, systemically important CCPs (Tier 2 CCPs) and non-systematically important CCPs (Tier 1 CCPs) from third countries to provide services in the Union.

So, I would support a swift conclusion of the EMIR 2.2 legislative file, complemented by a transitional provision allowing for the continued access to UK-based CCPs, subject to conditions ensuring that UK CCPs continue to comply with EMIR requirements and colleges continue to monitor this compliance.

A final comment that I would like to make is not only relevant for trading and central clearing, but generally for supervision and enforcement in securities markets. In the case of a no deal Brexit, NCAs and ESMA should have in place with our UK counterparts the type of MOUs that we have with a large number of third country regulators. These MOUs are essential to meet our regulatory objectives and allow information exchange for effective supervision and enforcement, for example for market abuse cases. ESMA has coordinated the preparations for such MOUs together with the EU27 NCAs. Taking the wider negotiations between the EU and UK into account, we plan to start negotiations with the UK FCA with the objective to have these MOUs in place sufficiently on time before the end of March 2019.

Thank you for your attention and I am looking forward to participating in a lively panel discussion.