

Liquidity and new financial market regulation

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Ladies and gentlemen,

It is a pleasure to be here in London today at AFME's 9th European Market Liquidity Conference. I am delighted to see that you have attracted such a large group of speakers and participants from the trading community.

Five years ago today the regulatory community around the world was preparing what would later become the G20 leaders' statement following the Pittsburgh Summit. It was the start of a regulatory and legislative overhaul and, one of the biggest globally coordinated financial sector reform ever.

Since then the EU has discussed and made amendments to almost all of its financial services legislation, in the securities markets area for example: the introduction of direct supervision of credit rating agencies by ESMA, the European Markets Infrastructure Regulation (EMIR), the Alternative Investment Funds Directive (AIFMD), the Transparency Directive, the Market Abuse Directive (MAD), MIFID etc.



Today the results of the new legislation are becoming more and more tangible for financial markets. In that respect, 2014 will become a crucial year, especially for anything to do with financial markets infrastructures. As you know the European Parliament and Council have reached an agreement on the MiFID II proposals at the beginning of January 2014 and derivatives reporting to trade repositories started just under two weeks ago

During today's talk I will elaborate on the work ahead of us on MiFID II, on defining liquidity within financial markets for MiFID II and on the implementation of EMIR.

Implementing MiFID II

Let me first turn to MiFID II, this will be the most significant project for ESMA this year and one of our biggest contributions to the single rulebook since its inception. The European Parliament and Council reached an agreement on 14 January 2014 on the proposal launched by the European Commission 27 months earlier, in October 2011. The final text is not available yet but the text published by the Council¹ contains a large number of empowerments for implementing measures where ESMA is expected either to draft technical advice for the Commission or to prepare regulatory technical standards. The work to be done by ESMA, on what would be called *implementing rules* on the other side of the Atlantic, should not be underestimated.

A simple search query reveals that ESMA appears 444 (four hundred and forty four) times in the MIFID/MIFIR texts. As a comparison, the word *financial* which is probably

¹ http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/141071.pdf



the most often used in MiFID appears 589 times. However, this does not mean that ESMA will need to develop 444 rules as these references to ESMA also include mandates to ensure consistent supervisory practices between national authorities, for example through issuing opinions or binding mediation between authorities and operational work, like receiving notifications or data publications.

The real number of empowerments to develop technical standards or advice is around 100. And the difference between the two (i.e. technical advice versus technical standard) is important. Where the Commission needs to adopt delegated acts it may ask ESMA for technical advice on which ESMA will consult the market through a single *consultation paper*, with the usual associated public hearing. However, for those areas where ESMA is required to develop technical standards, we intend to first publish a *discussion paper* and hold a public hearing on the key strategic elements before beginning the more detailed drafting. This process should allow sufficient input to develop the draft technical standards – on which we will consult the public again later in the year/early next year (through a “consultation paper”).

Transparency and co-operation are for good reasons among ESMA’s core values. We strongly believe in the benefits of public consultation and discussing our proposals with market participants and the wider public. However, knowing that the deadline for delivering technical standards and pieces of advice is strict it generally varies between 8-9 months for technical advice and 12 months for technical standards, this might become a challenging task. Nevertheless, ESMA started its preparatory work a number of months ago, and expects to issue the discussion paper shortly after the approval of the final text



by the European Parliament.

Liquidity and MiFID II

So far so good about process, let me turn now to the substance. MiFID is among the most important acts of legislation for EU financial markets that we have because it is about the way in which capital flows into the economy. Markets are about funding economic growth and hedging risks and are of paramount importance to the real economy, investments, jobs, pensions, in short our futures.

Since 2007 MiFID has undoubtedly increased business opportunities through competition and enhanced investor protection within the EU. The unprecedented harmonisation of securities markets legislation, and the resulting open architecture, ushered in by MiFID I, especially in trade execution and reporting, has resulted in profound changes within market infrastructures. MiFID II will continue along that path. Especially as there is a clear political willingness and agreement – and this is also reflected in the legal act – to increase transparency for example by including more financial instruments, ranging from equity-like to non-equity financial instruments, within the scope of MiFID. Market practices, and possibly market structures, will change as a result of this.

I know that some of you are concerned about this but things cannot stay as they are today. MiFID II has an explicit intention to transform and improve the way European financial markets work. When developing technical standards and advice ESMA will have to ensure that pre- and post-trade transparency for equity, equity-like and non-

equity instruments is increased, in particular for those instruments, such as derivatives, that are still far from being traded in a fully transparent market. There are endless debates of the relation between transparency and liquidity and whether there is a trade-off between them. We tend to see the MiFID II mandate as one aimed at increasing transparency in a manner that does not damage, but improves, the functioning of the market.

But what is liquidity? It is easier to recognise than to define. As a starting point one can say that liquidity is the likelihood of being able to trade at a price equal or close to the price of the last transaction. But how does one make that operational? Since the creation of ESMA three years ago we have had many discussions – to be honest often very difficult ones – on how to define liquidity in the context of EMIR, the Central Securities Depository Regulation (CSDR), International Financial Reporting Standards (IFRS) etc. yet so far no single definition has emerged. And yes, our colleagues at the EBA and EIOPA are having similar debates and may well come to different conclusions. That is not necessarily a problem in itself as we always need to keep in mind what we are trying to achieve and for what purpose we are defining liquidity. The EBA, EIOPA and ESMA have in that context even different regulatory goals.

We are also aware of the significant impact that our future regulatory work under MiFID II may have on liquidity within EU financial markets. But this is not a completely new element of our work. We already monitor and assess today securities markets in order to identify trends, potential risks and vulnerabilities and report comprehensively on these issues on a regular basis. In doing so we pay particular attention to liquidity risk, as this

can easily be altered by drivers such as financial innovation, the interest rate environment, regulatory standards and the business cycle to name just a few.

Over the last months we have seen signals for improved liquidity as well as the persistence of previous tensions in bond markets:

1. After a substantial fall in the third quarter of 2013, bond volatility continued to decrease at the beginning of the last quarter of 2013. Volatility for short term bonds however increased sharply as of October 2013, whereas it remained stable for longer maturities;
2. Despite a slight decrease in bid-ask spread of euro area sovereign bonds with 10 year maturity between the fourth and third quarter, liquidity conditions remaining different across Member States; and
3. Finally, issuance of sovereign bonds in the second half of 2013 was lower than the issuance in the first half year, reaching its lowest level since 2008, down 32% from 630bn EUR in the first half year of 2013 to 429bn EUR.

From this evidence, it is clear that liquidity in the bond market is still fragile and that ESMA's regulatory framework may have a critical role in order to safeguard the functioning of this market and its liquidity.

ESMA will have to set specific quantitative parameters in order to assess whether a financial instrument has a liquid market. To that end, Article 2 of the draft MiFIR sets specific criteria to be considered when determining quantitative thresholds aimed at

assessing the liquidity of a market, namely:

- (i) the average frequency and size of transactions having regard to the life-cycle of products;
- (ii) the number and type of market participants; and
- (iii) the average size of spreads, when available.

ESMA will carefully analyse the market model and the peculiar characteristics of bonds, across asset classes and at the individual instrument level in relation to the parameters provided by Level 1, because a bond's liquidity might be driven by many other different factors such as issuance size, currency, maturity, credit quality, seasonality etc.

Looking at trading patterns, the large transaction volume of trading in a particular bond category may be the result of a different trading pattern, either infrequent but large trades or frequent but small trades. Furthermore, fixed income instruments trade in a large range of trade sizes, whereby individual trade sizes are usually driven by the nature of investors' investment strategies. As a result, different trading patterns may exist across different types of bonds. In addition, there are differences at the individual bond level, for example on-the-run bonds, which are characterised by a more intensive trading activity than off-the-run bonds, and as a result, are considered more liquid.

But what are the consequences if an instrument is deemed to be traded in a liquid market?

First of all, real time transparency obligations will apply, whereas illiquid instruments –

generally speaking – can be exempted from pre-trade transparency obligations and can *benefit* from post-trade deferred publication. Pre-trade exemptions aim at protecting investors from adverse market impact while post-trade deferrals should encourage the provision of liquidity to the market. As a result, the correct calibration of liquidity thresholds will be critical in order to provide investors with the right balance between transparency and protection.

Secondly, whenever there is a liquid market, a systematic internaliser should be obliged to publish firm quotes, execute clients' orders and give access to their quotes in relation to non-equity transactions below the size specific to the instrument.

We are well aware of the differences between equity and bond or derivative trading: the role of dealers, the *inventory* dimension of bond trading, the market making that allows some products to be traded, the lifecycle of bonds and its relation to liquidity, to name just a few. However, we should also recognise that *different* liquidity does not always mean *lower* liquidity.

At some point in their life, some bonds and many derivatives might even be much more liquid than the average share in the EU. Saying immediately that they are not suitable for transparent trading might be a bit too easy, as we are already seeing the centralisation by some trading platforms of some products that were until a few months ago only traded over the counter (like some swaps) and were lacking post-trade transparency. For instance, as we speak, there are platforms trading interest rate swaps with spreads of 1 or 2 basis points and 200 million EUR depth on each side of the order book, something



many shares will never achieve.

Liquidity in secondary markets is thus far from a static concept: it changes, not only as a result of the inherent features of the asset and the market but also due to events in the wider economy. Consequently, all these considerations will be relevant, not only for setting the specific quantitative parameters determining if a market for a financial instrument is liquid or illiquid but also for setting the frequency of threshold recalculation and recalibration.

We have already started dialogue with our international counterparts, such as those in the United States, where transparency requirements for non-equities were adopted earlier, and with ESMA's consultative working groups which gather together financial market participants. But we also need your help. In order to allow ESMA to calibrate parameters and transparency requirements adequately for each instrument or category of instruments, I would like to invite you to share all possible evidence with us. The work we are carrying out in this area is highly technical, demanding and time-consuming – all of which underlines the importance of public consultation. Providing ESMA with data, studies and market statistics will allow us to analyse market developments and, in turn, to draw the most appropriate regulatory conclusions in the best interest of the European Union.

Once defined, ESMA will monitor the market evolution to ensure that the thresholds remain adequate or if changes in market conditions require different parameters. Furthermore, and probably on a more frequent basis, liquidity of bonds and the related

applicable transparency regime will be considered. In this respect, there is room for combining reference data per financial instrument, together with the related transparency and liquidity thresholds calculated by the national competent authority in a unique user-friendly system. In addition, I personally believe that centralisation of data at EU-level would ease the accessibility and usage of this information across all European markets.

To conclude, protecting the liquidity of the bond market is of paramount importance. However, even if the concept of liquidity in the equity market cannot be mechanistically extended to the bond market, this does not necessarily imply that transparency rules should be more lenient for bonds or derivatives with respect to equity in all cases. As I said earlier, the right calibration of the thresholds, which will be based on different parameters with respect to those provided for the equity market, will ensure that the ability of trading firms to provide liquidity will not be undermined and that the impact on trading costs for investors will not limit the ability of governments and companies to raise capital.

Other aspects of MiFID II implementation

MiFID II is about more than defining liquidity. With regards to micro-structural issues, topics such as mechanisms to manage volatility, where ESMA has to deliver a new set of guidelines, market making schemes and strategies, fee structures, tick sizes and maximum order to trade ratios will also have a significant impact on the market.

ESMA's work will also embrace brand-new topics such as mandatory position limits and



position reporting for commodity derivatives, reasonable commercial basis and non-discriminatory access to trading venues and CCPs, highly controversial areas that have not been at the core of the activity of financial regulators in the EU in the past.

The work on organisational requirements of trading venues will mainly focus on drafting rules for the SME Growth Markets with the aim of increasing its liquidity, as well as, on topics crucial for the orderly functioning of European markets, such as admission to and suspension of trading of financial instruments.

Finally, I believe that it is fair to say that MiFID II will determine a more prominent operational role for ESMA in the upcoming years. Although I know that equities markets are probably not at the top of priorities for this audience, a clear example of this is the double volume cap mechanism aiming at limiting trading under the reference price and negotiated trade waivers foreseen in MiFIR. In this context, ESMA will be required to calculate the amount of trading carried out both under the waivers and as a whole on each trading venue and per financial instrument, in order to check if the trading activity under the waivers on a trading venue approaches or exceeds certain thresholds.

As in the case of EMIR, to which I will refer later, the work for ESMA does not end with the delivery of technical standards and advice for which it is mandated. Similarly, for MiFID II, the next step for ESMA after the rule making will be the implementation phase of the new regulatory framework. Among the different tasks, the trading obligation, to determine which derivatives should be traded on venues, is one of the most important ones that ESMA will have to tackle.



Given the wider scope of Level I, ESMA expects to process requests and issue opinions on pre-trade waivers on a more frequent basis and for a multitude of financial instruments, but also to be involved in decisions around the compatibility of national competent authorities' proposed position limits for commodity derivatives.

Lastly, but not least, ESMA expects not only to maintain and publish up-to date information related to the transparency and micro-structural regimes provided for in Level 2, but also to monitor their consistent implementation and assess their effects on EU markets so as to finally recalibrate the parameters of these regimes on a periodic basis.

EMIR implementation

Let me now move to the implementation of EMIR. Having touched, with MiFID II, upon ESMA's contribution to the creation of a single rulebook for financial services across the EU –probably our best known activity, I will now talk about how our work on post-trading is expanding ESMA's role as a direct supervisor, and in working towards achieving convergence in supervisory practices between EU Member States.

For many people the lack of transparency – and, in consequence, the lack of understanding on what was going on – in relation to OTC derivatives is a symbol of the urgent need for more adequate regulation after the financial crisis. The EU's response to that issue, EMIR, quickly became an important backbone of European financial markets regulation. For ESMA it includes among others the responsibility for direct supervision



of trade repositories.

Besides the 22 credit rating agencies which are currently supervised within the EU, ESMA is now also supervising the six trade repositories it authorised last autumn. With those authorisations, the reporting of derivatives started two weeks ago, on 12 February 2014. This is a major step forward in the implementation of EMIR and, more broadly, the G20 commitments. It will bring clarity and allow for greater supervision of previously opaque markets, at least for EU supervisors.

We know that EMIR has been a major project for many firms and infrastructures. It involves ten times more firms than the MiFID reporting system, which is available to securities and markets authorities by investment firms and only for instruments traded in regulated markets, much more complex products, many without an ISIN-code, with limited preparation time, months, rather than years.

We are conscious of the challenges companies are faced with in the preparation of systems and the refinement in the reporting systems. Although the general exercise has gone reasonably well given all these constraints, we are well aware that there are still numerous issues to be solved in terms of onboarding of reporting entities, identification of the legal entity identifier (LEI), ensuring harmonisation of codes, and improving data quality etc. ESMA has provided guidance about how to populate reports on three occasions in the last few months and is currently working on further initiatives in that field. As we have seen in other jurisdictions, that started off with reporting earlier than us, it takes some time to have a system of this size and complexity running smoothly and



providing top quality data for supervisors at a global level. But we are well on the way and the goal is worth the effort.

In addition, I am sure that the competent authorities that have the power to enforce non-compliance on reporting parties at national level, are conscious of the limitations and the sheer scale of such a big project and are working with the supervised entities and ESMA to improve their reporting quality in the shortest possible time period.

That brings me to the last part of my contribution today.

Technical standards and advice contribute to the creation of a single rulebook. However, we cannot rest on our laurels after developing a single set of financial regulation across the EU or at international level. Regulation should also be applied and supervised consistently within a single market, or to say it with the words of Tommaso Padoa-Schioppa – a founder of FESCO, one of the predecessor bodies of ESMA – “cross-border supervisory cooperation should be so strong and effective that the collective behaviour of supervisors would appear as a single one”.

ESMA has received over 1500 questions on the implementation of EMIR which resulted in the publication of more than 50 sets of questions in six publications aimed at providing a convergent way of applying EMIR in the daily practice of each national competent authority. As you know Q&As are not binding, only technical standards are, as they go through the full legislative process, but they also take quite a few months to finalise, but their importance and peer pressure effect should not be underestimated.



The Q&As have helped ESMA to clarify the application of some aspects of the law in a swift manner and ESMA will continue to do so. We can expect a similar process when the MiFID Level 2 enters into force, which will keep us very busy well into 2017.

However, not all matters can be clarified through Q&As or by ESMA. In that respect, about one week ago ESMA sent, on 14 February 2014, a request to the European Commission to clarify the scope of MiFID and EMIR when it comes to certain derivatives.

ESMA noted the lack of clarity of the definition of foreign exchange forwards and physically settled commodity forwards when it comes to their inclusion in the MiFID list of financial instruments for the purposes of applying the EMIR provisions. MiFID was developed before the start of the crisis to which EMIR is a response. It is not surprising that the goal and purpose of MiFID in relation to FX derivatives was different from EMIR's objectives and that more clarity is needed of what is the exact frontier between spot and forward markets and on how to treat FX derivative transactions used for commercial purposes. Whilst waiting for the European Commission's clarification ESMA has proposed not to apply the EMIR provisions to those contracts where there might be differences in terms of their classification as derivatives across Member States.

Ladies and gentlemen, to conclude, I would say that the EU is on its way to fulfilling the G20 commitments and is progressing well towards more transparent and fairer financial markets, but there is a lot still to come. ESMA will work hard and I am convinced that you share our objective to ensure we establish well-functioning financial markets across



the EU.

Thank you!