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MiFID II – Switching on the light without turning-off the tap

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Ladies and gentlemen,

It is a pleasure to be here in London today at the ABA/LAW Society Capital Markets Conference. I am delighted to see that you have attracted such a large group of speakers and participants from the global capital markets legal community to discuss the future of capital markets.

The last 7 years have been unprecedented in the history of financial markets. The world has been hit first by a financial crisis which was then followed by an economic crisis. The G20 reacted by committing to the biggest globally coordinated financial sector reform ever. Six years ago the regulatory community around the world prepared what would later become the G20 leaders' statement following the Pittsburgh Summit. Since then the EU has discussed and overhauled almost all of its financial services legislation, including the creation of a new supervisory system with the three European Supervisory Authorities ESMA, EBA and EIOPA and the European Systemic Risk Board. A look at the financial services legislation in ESMA's competence reveals how fundamental these changes were:

- the introduction of direct supervision of credit rating agencies by ESMA,
- the European Markets Infrastructure Regulation (EMIR),
- the Alternative Investment Funds Managers Directive (AIFMD)
- the Central Securities Depositaries Regulation (CSDR),

- the Market Abuse Regulation (MAR),
- MIFIR/MiFID II etc.

Today, the results of the new legislation are becoming more and more tangible for financial markets. The system has stabilised, although still fragile, and the focus now starts to move towards an agenda to create growth and jobs. Last week the Commission presented its Green Paper for a Capital Markets Union, which launches a broad discussion on how to achieve genuinely integrated capital markets across the whole Union.

MiFID II and MiFIR (MiFID II in the following), so often called the 'cornerstone' of legislation of EU financial markets, contributes to both the stability and the growth agenda. Firstly, MiFID II is about making financial markets more stable, more transparent and more diligent in their duty of catering for investors. Secondly, MiFID II 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 and pensions, in short - all of our futures. The Capital Markets Union and MiFID II go hence hand in hand.

ESMA's work on MiFID II implementing measures – process

MiFID II will be the most significant project for ESMA this year and one of our biggest contributions to the single rulebook since its inception. After more than two years of negotiations, the co-legislators reached an agreement in the beginning of 2014 and the final texts entered into force on 2 July 2014. While the new rules will only apply as of 3 January 2017, this does not imply that now is a time to rest. Rather to the contrary since MiFID II provides for a large number of empowerments for implementing measures, so called level 2 measures, to be prepared by ESMA. ESMA is conducting this policy making work through two routes: first, preparing technical advice to guide the Commission in the development of implementing measures; second, preparing draft technical standards on a number of very important technical elements. Drafting regulatory standards and technical advice is only one element of ESMA's role under MiFID II, although currently the most important one. Other elements – which will come more to the fore over the next few months and years - include

a) ensuring consistent supervisory practices between national authorities, for example through issuing opinions or binding mediation between authorities and
b) operational work, such as receiving notifications or publishing data.

Given the sheer amount of empowerments for developing implementing measures (there are more than 100 empowerments in MiFID II) and the very tight deadlines (Jan 2015 for the technical advice, 3 July 2015 for regulatory technical standards, and 3 January 2016 for implementing technical standards and some guidelines) ESMA had to start working on these during the final phases of the negotiations of MiFID II. We have already made significant progress in 2014 and delivered on the first part of our mandate by submitting our technical advice to the Commission on 19 December 2014 following a public consultation in the summer and a public hearing. Based on our advice the Commission is now developing the relevant implementing measures.

We are also on track for the delivery of the draft regulatory technical standards, those implementing measures where ESMA is genuinely in charge and holding the pen. Following a first round of early consultation last summer, we published a Consultation Paper, including the draft technical standards and a qualitative cost-benefit analysis, on 19 December 2014 (which, by the way, I am told that even stimulated some to create Christmas carols inspired by it, like the famous hit "MiFID II is coming to town"!). The consultation is still open until 2 March. Last week, on 19 February, ESMA organised a second public hearing with more than 400 participants providing us with some feedback on our proposals. Last but not least, ESMA published last week an addendum to its December consultation paper covering the calculation for transparency requirements on derivatives classes that were not covered in the December consultation; that is CDS, foreign exchange derivatives, contracts for difference, and exotic derivatives. You can respond to this consultation by 20 March. You can expect further consultation papers towards the summer on the implementing technical standards and some guidelines that we have to deliver by the end of this year.

In parallel to finalising the technical standards we are investing significantly in further substantiating our cost-benefit-analysis to get a better understanding of compliance costs and to quantify, to the extent possible, broader costs and benefits stemming from our proposals. We will shortly be distributing a questionnaire to most of your firms as well as to other market participants asking for your input on costs and benefits. Your input will be crucial in enabling us to properly assess the impact of our measures and to adjust our proposals where necessary. Therefore, whilst I understand that completion of these questionnaires puts you under more pressure at a time when demands are heavy, I do urge you to invest time in this to help us develop appropriate rules, which will ultimately benefit the whole market and our economies.

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. I am aware that the deadlines of our consultations are challenging and that in an ideal world we should give you more time. But ESMA is also bound by demanding legislative deadlines, which unfortunately constrains the time we can give market participants to respond to consultations.

Liquidity and MiFID II

So far so good about process, let me turn now to the substance.

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 to the markets, their structures and the market infrastructures that support them. MiFID II continues along that path. Especially as there is a clear political willingness and agreement 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 no doubt 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 the explicit intention to transform and improve the way European financial markets work. This was the intention of the co-legislators and ESMA needs to respect that intention when doing its work. When developing technical standards and advice ESMA needs therefore 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 about 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 instead improves, the functioning of the market.

I will present to you today the non-equities transparency regime, clearly the most controversial and complex part of the MiFID II transparency regime. Explaining all the elements of our proposals is a challenging task in itself, and clearly an impossible one in a short speech. I will therefore focus on the areas generating most comments starting with some general remarks on the differences between equities and non-equities before providing you with a glimpse of our proposals in three areas: firstly, the definition of instruments for which there is no liquid market; secondly the large in scale and size specific to the instrument waivers from pre-trade transparency and deferrals from post-trade transparency; and thirdly the calibration of pre-trade transparency requirements for different types of trading systems, and in particular 'request for quote' systems.

The controversy about trade transparency for non-equity is linked to the differences between equities and non-equities and the concern that these will not be sufficiently taken into account when calibrating the transparency regime. I can reassure you, this is not going to be the case and we are well aware of these differences of which I will highlight only two:

1. The scope of financial instruments within the non-equities class is very broad ranging from fixed income and structured products to interest rate swaps and emission allowances, to name only a few. And within each of these asset classes there might be large differences. For example, looking at fixed income, it makes a big difference when calibrating the transparency regime whether you are talking about a sovereign bond with a high credit standing, which trades regularly, or you are talking about a corporate bond issued by a small, relatively unknown non-financial institution which trades infrequently.
2. The market structure is very different: Whereas most equity markets are centralized and order-driven markets, non-equities markets are more decentralised, dominated by institutional investors and dealers who play a key role by providing quoted prices.

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 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. Indeed we are already seeing the centralisation by some trading platforms of trading in some products that were, until a few months ago, only traded over the counter and were lacking post-trade transparency (like some swaps)

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We should also recognise that the EU is not the first jurisdiction introducing transparency in this market. For example, when the US introduced in 2002 TRACE, a post-trade transparency regime for bonds, market participants were very concerned about it having detrimental effects on market liquidity. Looking at the impact of TRACE after more than ten years, this did not prove to be the case in general. A significant number of studies have analysed the impact of TRACE and most of them could not find evidence of reduced liquidity (except for the less liquid part of high yield bonds) with some of them even concluding that TRACE has helped increase liquidity. Those studies have also shown lower price dispersion after the introduction of transparency.

We are aware of the significant impact that our future regulatory work under MiFID II may have on liquidity within EU financial markets. This is not a completely new element of our work. We already monitor and assess 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, prudential regulation, the interest rate environment, regulatory standards and the business cycle to name just a few.

To conclude on this general discussion on liquidity and transparency: this is not about providing full transparency, but the right amount of transparency. ESMA is striving in its calibration of the transparency regime to reflect the particularities of non-equities so that the benefits of transparency are brought forth without undermining liquidity. This inevitably introduces some complexity.

The concept of a ‘liquid market’ plays an important role in MiFID II not only for the application of real time transparency obligations (which will apply to instruments with a liquid market) but will also impact the quoting obligations of systematic internalisers and the trading obligation for derivatives. For instruments not having a 'liquid market', MiFID II provides for the possibility to waive pre-trade transparency and to grant deferral from post-trade transparency for transactions in such instruments. In other words, in general only instruments with a liquid market will be subject to real-time trade transparency.

MiFID II, already at Level 1, sets specific criteria to be considered when determining quantitative thresholds for assessing the liquidity of a market. Based on these criteria, and on feedback we received from our earlier consultation, ESMA proposes to use the average frequency and size of transactions as the main criteria to be used to determine a 'liquid market'. Most respondents to the consultation supported this proposal.

More challenging and controversial was the choice of methodology for assessing liquidity. MiFID II Level 1 provides for two methodologies on which ESMA consulted:

- the instrument by instrument approach (IBIA), whereby the criteria are applied to each financial instrument individually, and
- the classes of financial instruments approach (COFIA), where the criteria are applied to classes of financial instruments, rather than to each individual instrument, with each individual instrument being assigned the liquidity of the overall class.

Feedback on which methodology to use was divided. After having considered the pros and cons of the two approaches, ESMA opted for COFIA across all non-equity asset classes. We took this decision for two reasons:

1. COFIA is considered to be a more stable and predictable system than IBIA; and

2. COFIA has the advantage of a straightforward assessment for newly issued instruments. Of course, COFIA also has shortcomings, the major one being that it is an approximation: some instruments will be allocated to a “liquid” class which do not meet the liquidity criteria; and similarly, some instruments within a “non-liquid” class will in fact be liquid. A necessary prerequisite for applying COFIA is therefore the proper grouping/segmentation of financial instruments into homogeneous and relevant classes. ESMA has identified for each non-equity asset class first the set of relevant qualitative criteria to segment the classes. In a second step each sub-class was assessed on the basis of quantitative criteria determining the liquidity of such sub-class.

The choice for COFIA and the problem of false positives, that is classifying illiquid instruments mistakenly as being part of a liquid class, is one of the major criticisms we are currently facing on the non-equities transparency regime. That is not a surprise, or an oversight, since we ourselves calculated and published those types of errors in the first place and ran simulations to minimise them. This is one of the areas on which we are and will continue to work and are performing calculations aimed at improving our approach and minimising misclassifications. Your input will be key for delivering a sensible approach! I would like to invite you to share data you or your colleagues might consider useful for these calibration purposes with us.

However, liquidity in MiFID is not an abstract concept, but a tool to calibrate the transparency regime, which has also other important filters and mechanisms. There are several EU Regulations or market practices that classify instruments as liquid or non-liquid. For instance, prudential regulation requires different financial resources depending on the liquidity of the assets. Monetary policy, collateral rules or the Short Selling Regulation all consider different concepts of liquidity, depending on the regulatory objective pursued. We have heard criticism of ESMA considering liquid, for instance, a bond that trades just twice a day. While this may be discussed, this should not happen in the context of an abstract discussion of liquidity, but in light of MiFID's aim to increase transparency and improve the functioning of markets. Each regulatory tool should be assessed with the goal it pursues in mind, as well as the other elements that counter-balance the definition. This is the way we tend to approach the issue of liquidity when thinking about it in the specific context of the MiFID transparency system. There are ways in which we aim to address the shortcomings of the COFIA approach, either by adjusting and recalibrating the classifications themselves, as just mentioned, or by adjusting the thresholds above which orders or transactions may benefit from a waiver or deferral. In other words, an instrument with a liquid market may still benefit from waivers from pre-trade transparency and can be subject to deferred post-trade transparency. Which brings me to the next element, the calibration of waivers from pre-trade transparency and deferrals from post-trade transparency.

The two most important waivers and deferrals are orders/transactions that are large in scale (LIS) or in a size specific to the instrument (SSTI). LIS is not a new concept and was already part of the transparency regime for shares under MiFID I. The LIS waiver intends to protect large orders or transactions from adverse market impact. The SSTI was introduced specifically for non-equities and aims to capture the situation where liquidity providers expose their own capital when trading these instruments and may therefore need additional protection not covered by the LIS. When calibrating the thresholds, we aimed at providing the necessary protection from adverse market impact while ensuring that MiFID II delivers on its ambitions and increases transparency. After having done various rounds of calculations our proposal in the current Consultation Paper is the following:

- The SSTI will be set at 50% of the LIS to reflect the need to provide stronger protection for market participants exposing their own capital;
- Fixed values for the SSTI and LIS thresholds in the first year of application; then

- As of 2018 a dynamic calculation of the thresholds based on the principle of ensuring that a significant amount of either transactions or trading values remain transparent. This approach is flexible and adaptable to different market situations and avoids an everlasting review of the technical standards themselves; and
- We opted for setting the LIS and the SSTI at the same level for pre- and post-trade transparency purposes to not add further complexity to the system.

We are aware that this approach and its current calibration are not flawless and need to be further improved. In particular, the SSTI threshold has been criticised by many market participants as being too high. We also consider that part of the concerns on the COFIA approach could be addressed by further improving the methodology for setting the LIS and SSTI thresholds and recalibrating the thresholds. We are carefully looking at these proposals and hope that responses to the consultation as well as the ongoing work on the cost-benefit analysis will provide us with more guidance and evidence on the right calibration of the transparency regime. 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 interests of the European Union.

Another contentious area of the non-equities transparency standard is linked to the calibration of the pre-trade transparency regime for different trading systems. MiFID II introduces two new trading systems reflecting trading practices for non-equities: request for quote (RFQ) and voice trading. ESMA is required to set the appropriate level of pre-trade transparency for orders advertised through the different trading systems, six in total (order-book, quote-driven, periodic auction trading, RFQ, voice, and hybrid trading systems). Our approach when calibrating the content of the pre-trade transparency requirements is aimed at ensuring that the requirements we set are compatible with the way the different trading systems work without undermining the level playing field between the different trading systems, by excessively burdening or privileging a particular type of trading system. We know that some of you are unhappy with our suggested definition on RFQ systems, which would require the disclosure of provided quotes to the public, and in particular we are aware of your concern that our approach might deter liquidity providers from providing quotes, and thus damage liquidity. This is certainly not our intention. However, we have to keep in mind that the pre-trade transparency requirements for orders advertised through RFQ systems stems from Level 1 and that ESMA's mandate is limited to the calibration of the transparency requirements for different types of trading systems. We are looking at ways to deliver a meaningful definition of RFQ systems which ensures an appropriate level of pre-trade transparency for RFQ systems as prescribed in Level 1 without removing incentives for market makers to provide quotes.

To conclude, protecting the liquidity of non-equities markets is of paramount importance. At the same time, even if the concept of liquidity in the equity market cannot be mechanistically extended to the bond and derivatives markets, this does not necessarily imply that transparency rules should in all cases be more lenient for non-equities compared to equity. As I said earlier, the right calibration of the thresholds, which will be based on different parameters from 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. In a nutshell, we aim at switching on the light without turning-off the tap.

Other aspects of MiFID II implementation

As you all know, of course, MiFID II is about more than defining liquidity. With regards to micro-structural issues, where ESMA has to deliver a new set of rules on market making schemes and strategies, fee structures, tick sizes, mechanisms to manage volatility and maximum order to trade ratios will also have a significant impact on the market. ESMA's work also embraces brand-new topics such as mandatory position limits and position reporting for commodity derivatives 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.

Although it is not the most glamorous area, in terms of market structure impacts, transaction reporting is an essential element in MiFID II, since it brings into existence for the first time a fully harmonised reporting regime: no national specificities, the same rules in all 28 Member States. But precisely because of that we need to get it right from the start. We have made a huge effort to present to you a fully-fledged, detailed list of fields and formats, even before the summer of 2014. And we will appreciate your detailed comments at this stage, since any later adjustments and improvements (after adoption) would require the full legislative process of new RTS.

Moving away from regulatory aspects to operational ones it is safe to say that MiFID II will lead to a more prominent operational role for ESMA in the upcoming years. A clear example of this is the double volume cap mechanism, which limits the use of reference price waivers and negotiated price waivers and which I assume most of you know already by heart. 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. This is to be done in order to check if the trading activity under the waivers approaches or exceeds certain thresholds. Providing an efficient and reliable calculation system is of utmost importance to ESMA. The implementation and the impact of the double volume cap will have to be closely monitored.

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 than currently and for a multitude of financial instruments. We also expect to be regularly involved in decisions around the compatibility of national competent authorities' proposed position limits for commodity derivatives. This represents a significant new task: new in terms of competence and significant in terms of volume with several hundred different commodity contracts traded in the EU. Finally, ESMA and national competent authorities have their own practical implementation challenges to face and are cooperating closely in order to meet these challenges, which include building or significantly recalibrating IT systems to be able to collect, exchange, monitor and publish a wide range of data points.

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 even when doing so in close alignment at international level). Regulation should also be applied and supervised consistently within a single market. Similar to EMIR, ESMA intends to develop Q&As aiming at providing a convergent application of MiFID II. As you know Q&As are not binding, but their importance and peer pressure effect should not be underestimated. The Q&As developed under EMIR 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 MiFID Level 2 enters into force, and this supervisory convergence work will keep us very busy well into 2017 we expect.

Last, but not least, MiFID will also be a step change for you. While 2017 seems still far away, it will come sooner than expected and now is the time to start preparing for the new regime. Also be aware that there is no transition into the new regime, the new rules will apply, with only some minor exceptions, fully as of January 2017. This means that we are already in the transition phase. The legislative framework at EU level should be fully in place by the end of this year; that is, all Level 2 measures should be in force. While the national transposition of the Directive might take a bit longer, you will nevertheless be aware of the key aspects of MiFID II by the end of this year. This gives you just one year to get ready for MiFID II, to adjust your internal processes and systems, to train staff, and to inform your clients. So, in effect, time is already short and the deadlines to get yourselves and your firms ready are fast approaching.

Ladies and gentlemen, to conclude, I believe that the EU is progressing well towards more transparent and fairer financial markets contributing to the sustainable growth of the economy, but there is a lot still to be done. ESMA will work hard, and will work with you, on our shared objective to establish well-functioning financial markets across the EU.

Thank you!