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"Capital Market Framework is not Cast in Stone"

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In your invitation, you mention a few international companies that have decided to turn their back on European capital markets. They pointed to liquidity and valuation among the reasons for their move. You say that Europe is losing out to Asia and the US in terms of capital market development. You also called the Markets in Financial Instruments Regulation the European constitution of our capital markets when it comes to transparency, integrity, and fairness in producing a good outcome for issuers and investors in what we call price formation. I agree with you that without efficient and trusted capital markets the CMU will not be successful, and companies will rather look elsewhere.

So where are we with MIFIR renovation?

As you probably know, in the European Parliament we have started the discussions among political groups based on amendments that are broadly structured around three main areas: consolidated tape, market structure and transparency, and best execution.

Let me share with you a broad overview of where the main differences are.

On the consolidated tape, there is a majority support amongst the political group for the launch of the bonds tape first. On the equity tape, the majority shares the ambition of the draft report and support the introduction of a pre-trade, real-time CT from the outset. But there are also amendments that propose a one-minute delayed, post-trade only CT for equity.

There seems to be a majority supporting the idea of an exclusion from the mandatory contribution of data for smaller regulated markets with a voluntary opt-in mechanism

There are also differing views emerging on which data contributors should be included in the equity revenue model. The view that all data contributors should be remunerated but that smaller regulated markets should be receiving a bigger share of revenue seem to be prevalent.

On market structure and transparency, some of the amendments favour a more restrictive approach towards dark trading, seeking in particular to increase the thresholds for SIs quoting and execution and for trading under the Reference Price Waiver.

Other amendments call for a revision of the dark trading thresholds and a simplification of the system, empowering ESMA to supervise the functioning of the market, rather than inserting fixed thresholds or limits at Level 1. We will need to carefully consider the amendments, to find what is the best set of measures to simplify the current rules and make them flexible enough, and to find the balance between strengthening trading on regulated markets and preserving the level playing field and the overall competitiveness of European markets.

On best execution and PFOF, as you know there are three options on the table, reflected by the amendments - the maintenance of the status quo, a total ban on the PFOF practice and a compromise that seeks to allow PFOF but only under certain conditions. The latter seems to be what the Council is currently considering - and we will certainly look closely at what they are doing as well. There are also broader considerations on the best execution regime in Europe - with some amendments notably proposing to ban all kind of inducements.

The debate on this topic is going to be one of the most difficult ones in the European Parliament, as much as it has been in the Council.

This review comes at a critical time for Europe.

European capital market needs to grow, be bigger, stronger and more unified. Its competitiveness. and attractiveness of matters especially in the context of Brexit. We now have a significant competitor at our doors that will use its regulatory framework as a tool for effective competition. The UK seems seeking to ‘deregulate’ , or at least make regulation lighter and more flexible. We need to give a hard look at what other jurisdictions do.

We should not be rule takers or engage in a race to the bottom. But we should avoid putting the EU capital market in a disadvantage. I believe all market players should be given a chance to contribute to the growth of the pie and benefit from it.

I understand that there is the willingness to strengthen regulated markets, but we need to remember that there is a wide diversity of market participants, and that the measures that we put forward should not create the situation where capital would flee the Union, rather than being attracted to it.

We need to consider giving enough powers and flexibility to ESMA, which as the EU supervisor can take decisions based on data and adjust the framework based on market evidence and market changes. That is the direction that we would like to take.

This file is very technical, but it is also very political - and it is evident that there are different national sensitivities.

As I said, we have to look for win-win solutions to make the pie grow from everyone - even if this means that there will be compromises from all sides.

Negotiations are under way, and they will probably last until the end of January, at least. We now have meetings with the Shadows planned in December and in January, and I trust that we will be able to achieve a satisfactory compromise.

Regarding market structure, one of the proposed objectives of the Commission's review is to ensure that the share trading on lit venues in the EU is approximately in line with ratios observed in other international financial centres.

You - and I think of FESE, Nasdaq, Deutsche Boerse- have mentioned that there has been a marked decline in the share of trading taking place on lit venues since the introduction of the first MiFID, and that this decline is detrimental to price formation. Other stakeholders, however, insist that lit platforms have maintained market share in the EU, and that there are no problems with price formation in the markets.

I believe that there is no evidence - according to a report from ESMA - that there is a problem with the way in which prices are formed in the markets in Europe. Still, one of the questions at the heart of the discussions on market structure is about the right balance between dark and lit trading.

In the MiFIR review we want to carefully look at how to calibrate the rules to influence that balance and maintain the level playing field between market participants.

One idea, for example, would be to increase pre-trade transparency by limiting the use of the reference price waivers (higher thresholds to use it) - this should drive smaller orders to the lit venues.

At the same time, one option could be to suspend and monitor the cap mechanism limiting dark trading under these waivers, as these caps were set arbitrarily and proved to be of limited utility. The suspension would reduce complexity and align the Union with international practices. In this case, to address the risk that the absence of caps will increase the amount of trading ‘in the dark’ (but this is counterbalance by higher limits on the use of the RPW), ESMA should be empowered to monitor and intervene.

These two measures together (higher RPW + suspension of caps) could strengthen lit venues but also make the regime more flexible. And would give a greater role to the European supervisor.

What MiFID introduced since 2007 is a multitude of execution venues - listing exchanges, MTF and banks, which trade against their own inventory and quote a price that they can offer. It is essential to maintain competition in the EU market, to ensure that different kind of investors have a variety of solutions that best fit their needs.

When we talk about market structure we need to consider that today in Europe the cost drivers are not only rooted in trading, but also in clearing and settlement (post-trade). Certain shares are basically on a “vertical silos”. You can only trade them in one or two platforms. Then you have to clear them in different and separate clearinghouses because platforms are not connected to each of these clearinghouses. Then you have to settle them and this takes place in a national settlement system.

Trading in Europe then becomes expensive, as you trade, clear and settle separately and there is very little competition in clearing and settlement because each trading venue is connected to one clearing house.

That is a big cost driver and that explains the debate that we have on PFOF, which is a phenomenon that developed as a consequence of the fact that trading has been expensive, and it becomes easier to aggregate small orders and execute them.

The system in the US leads to lower costs as all listing exchanges compete, they all trade the same shares - then there is a funnel, and they all go into the same clearing and settlement system (DTCC or a subsidiary). This is an integrated market.

The money that asset managers manage is retail money (pension funds for example). But it has to be handled differently than when individuals invest by themselves. Institutional investor trading multi-million orders need to ensure that the price does not move against them when they place an order - and this is why dark pools can actually produce beneficial and needed effects as they allow to reduce price fluctuations.

Market needs diversity. The more constraints are in place, the bigger the risk that trading can be driven offshore. On EU equity market, 75-80% of the order flow from institutional investors come from non-EU investors. Most of the money in Europe is money from outside EU. All that volume is not subject to EU STO or other regulations - it can be traded anywhere. This must be remembered when the whole system is designed.

If you take the example of the Reference Price Waiver, we have seen amendments that are proposing a minimum order size of 2XSMS (around €20.000, depending on the market) for which you can apply the waiver and trade at mid-point. But that is very high - and more than 90% of all orders from mid-point will not be permissible below such a threshold. In that case the question is: will all these brokers or asset managers go to a EU lit venue - or if they can will they go to an outside venue where mid-point trading is available? There is no certain answer, but the point is that we need to assess carefully the possible consequences.

To an extent, we need to avoid a situation similar to what happened with derivatives trading post-Brexit. We did not see much movement from the UK to the EU, but rather to the US. Whatever we decide politically, we need to understand that this is about international competition.

On systematic internalisers (SIs), let me first say that SIs is a legislative framework covering a variety of business models. On the one hand you have market makers, like for example Jane Street, Citadel, making their money based on the fact that they sell high, and they buy low.

Then you have the bank SIs with clients offloading large orders and the bank will be a ‘shock absorber’, committing its own balance sheet and offering a price to the client. The bank will then take the position and will have to unwind that position on the market (through RM, MTFs...)

They therefore fulfil an important position in the market. It is true the average order size of SIs has decreased in the last few years, and that their function originally was not to execute small orders. We are addressing this in MiFIR by looking at the thresholds related to the SIs quoting and execution, and at how much can be done ‘in the dark’. Preferably ESMA should have a strong role in calibrating the rules in Level 2 and overseeing the functioning of the market.

But we also need to simplify the current regime in order to preserve the level playing field between venues and maintaining a number of choices available for the different types of trading needs - including trading through an SI.

For example, we are looking to restructure the regime by increasing the minimum order size for quotation and execution by SIs. Here, the proposal is to mandate ESMA to define what that should be. And we are also looking to review the rules around the definition of SIs - decoupling the status of an SI from the reporting obligations. This is because today in order to report a trade the status of SI is necessary and this has led to an inflated number of SIs in the European Union.

Some of the issues that we face today in the EU capital markets are rooted in European financial culture. Shifting people investment interest from banking sector to capital market requires education and then ensuring that when they do approach the market, they do not find it complex and costly. Simplifying the current transparency framework can improve the current market structure and make it more understandable and accessible to all investors

It can also create a level playing field between the different actors in the market

On PFOF, it is absolutely clear that this debate is going to be the most difficult in the European Parliament, as it has been in the Council.

As you know there are three options on the table - the maintenance of the status quo, a total ban on the PFOF practice, or a compromise that seeks to allow payment for order flow but only under certain conditions. The latter seems to be what the Council is currently considering - and we will certainly look closely at what they are doing as well.

But speaking more broadly about the issue, there is a direct question we need to ask - and that is: does the current best execution framework work?

My impression from the conversation with stakeholders and experts is that the best execution included in MiFID level 1 is so loosely worded that there are different interpretation at national level. The issue of payment for order flows is the most obvious example of this divergence of supervisory interpretations. The fact that you have national supervisors with radically different positions on the same topic is absurd. We need to have a more granular definition of what is best execution.

The CT can be one element that helps to ensure that the best execution framework is improved. And for best execution maybe a pre-trade tape is even more important than a post-trade tape, as it would show a benchmark against which brokers will be required to prove that the price at which they executed was the right one. We have seen in the Council that the French proposal share this line of reasoning, proposing that PFOFs would be allowed only if they led to an order-by-order price improvement, amongst other conditions.

What we have today has to be changed, as in the current system the same practice is allowed in certain countries and banned in others, creating an unlevel playing field.

There are several studies showing how the PFOF impacts retail investors as the brokers forward the orders to whatever venues pays them the highest PFOF.

ESMA has said it several times that PFOF can sometimes lead to brokers not acting in the best interest of their clients, but rather based on the payment they receive.

But there are also other studies - one that came out recently from the University of California as well - that suggest that PFOF venues do not cause worse execution for retail investors, but they offer them prices comparable to those that they will be able to obtain through other brokers.

One way to solve the issue would thus seem to be assessing best execution by comparing the execution price at a PFOF venue against a benchmark such as that of the tape. But other solutions are also possible.

It is also clear that disclosures rules for brokers should be strengthened and be more transparent. Brokers should be required to provide clear and intelligible information to their clients, in relation to each trade they execute, specifying for example at what price that was executed, and how it compared to the price on other venues. But brokers should also be required to make public aggregate information on their trading practices, and for example how much PFOF they have received, from whom.

The discussion around PFOF more generally links to the discussions on the inducement regime.

And while the role of inducement is still to be discussed in the context European legislation, it is clear that the EU should have harmonised rules on its best-execution framework and in this particular case also on if and how PFOF is allowed.

We cannot afford to have national rules and national interpretations. It is not benefitting Europeans.

When we talk about the Consolidated Tape, we need to go back to the issue of market structure and the fragmentation of European markets. The high number of trading venues favours competition, which was the intention of MiFID 1.

But the many choices for investors have then led to market data fragmentation - which is what the Consolidated Tape aims to reduce.

We need to consider that today it is very difficult for investors to navigate the markets, because they are fragmented. Today you have to pay to access real time pre-trade prices and volumes - and if you want to see the prices in different venues to choose where to execute your order, then you have to pay the data feeds of different venues, increasing the overall costs and complicacies of trading.

The Consolidated Tape would offer a consolidated view of not just the prices (best bids and offers) but also of the available stock. That would allow comparison across venues.

The CT can partly resolve the current home bias in trading - today retail flow is most of the time at national level, because finding trading opportunities anywhere else is either too costly or too burdensome. By making the identification of trading opportunities elsewhere easier, the CT could facilitate cross-border retail investors flow.

The Consolidated Tape would benefit asset managers of smaller sizes, as well as funds which manage the money of European retail investors. There could therefore be a direct benefit to retail investors across Europe, as - either directly or indirectly - the costs associated with trading will be reduced.

But it will also benefit the EU markets as a whole - including all participants to the markets - because it could potentially increase their attractiveness and drive more liquidity and more trading to the regulated markets. And it could enhance the visibility of venues that today are hidden because of the selection bias of investors (i.e. because market data is so expensive, investors select what market data they want to see and pay for, and this often tends to exclude certain venues for example in Eastern Europe from their selection).

There are discussions on how fast should the Consolidated Tape be. When the discussions on MiFIR started there were calls for the Consolidated Tape to show the data at the end of the day. Then there were calls for a 15 minutes delay. And now there are many amendments in the Parliament calling for a 1- minute delay. But if you are talking to investors, people who have their pension money in a given share, they need real time information to trade. If you have a time lag, then you miss out on every single opportunity.

And today the 15 minutes delayed data is already available for free, anybody can scrape the internet and consolidate it. It is purely that nobody actually believes that delayed data would generate any revenue, so no one wants to do it.

We have heard that a CT is not needed because data aggregators today already provide a consolidated view of close to 97% of the entire trading volume in Europe. But accessing data vendors is very costly. You still have to licence every data feed from every venue. For that, you need auditors, accountants and lawyers, even before you pay the fee for the data itself. It is hugely complicated. And it drives up the overall cost of trading and of market data. Today, this is one of the biggest problem that we have in Europe's capital market, and ESMA also identified this in its report on market data. Technical barriers are also often referred to, either by referring to latency issues or ghost liquidity. The latter can be solved by excluding non-actionable quotes from the CT and there are technical solutions rather easy to implement (for example, a filter that can be selected by the users of the CT).

On the latency, big, professional investors and market makers will continue to buy low-latency market data. But for asset managers and retail investors the CT will be an improvement, as they need to know where prices are and need to be able to react quickly. But they do not need low latency. Even 1 second would be absolutely sufficient for the use cases. But then 15 minutes or 1 minute is way too late, as the opportunities in the market will be gone in that amount of time.

The exchanges will lose revenue. Every exchange has a monopoly on its own market data. But a CT is not going to deprive exchanges of all their data revenue. Every trading firm, market maker, will continue to buy the direct low latency fees - that will not be impacted.

We know that small exchanges make less money on trading because their stocks are less liquid, and they are more dependant on their market data revenue. There is therefore a political as well as industry consensus on the need to ensure that the CT that we introduce does not damage the viability of EU exchanges.

There is the possibility of excluding smaller exchanges from mandatory contribution, or to redistribute part of the revenue of the CTP towards data contributors, skewing the share of that revenue in favour of pre-trade transparent venues, and even more towards smaller exchanges.

Few words on market data. In Europe they are very costly because ESMA's guidelines on the reasonable commercial basis have often not been respected and/or implemented uniformly across the Union. To address this, and in line with ESMA's advice, we are including a more granular definition of 'Reasonable Commercial Basis' in Article 13, mandating ESMA to further define it at Level 2. This should provide a certain degree of harmonisation across the Europe and help define the value of market data.

But there are also problems with market data quality, particularly in the non-equity space. That is why we want to strengthen the role of ESMA in taking decisions on the basis of data, and we want ESMA to remain the main body in charge of setting the rules about transaction reporting, data standards and data interpretations. On bonds, for example, the introduction of the Consolidated Tape and the RTS that ESMA will be mandated to implement for the functioning of the CT should lead to improvements in data quality.

And let me finish by making some references to the US capital market. In the US, they have the CT on equities market since 1995 on pre- and post- trade. In the bond market since 2002. In the US they also have a fragmented market (with different players) and to deal with fragmentation they started pushing the CT to 'manage' transparency. So, capital market framework is not cast in stone.