German Banking Industry Committee

Die Deutsche Kreditwirtschaft

# Comments

## Review of the regulatory framework for investment firms and market operators (MiFIR)

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**Comments** Review of the regulatory framework for investment firms and market operators (MiFIR)

## I. Executive Summary

We welcome the opportunity to comment on the legislative proposals dated 25 November 2021 for a revised MiFIR Regulation (MiFIR).

Over the past four years, i.e. since the application of MiFIR, market participants and supervisors have gained extensive practical experience in the environment created by MiFIR. This experience has shown that the application of the new requirements for market structures has increased transparency and enabled competition to work in the interests of investors. The key objective continues to be that the market should match supply and demand efficiently.

The current review offers an excellent opportunity to further optimise cross-border capital market integration and to booster the competitiveness of the EU27 financial marketplace. The EU27 regime should naturally continue to meet high standards; but this target could also be met with fewer and less detailed rules. Both supervisors and supervised market participants should be relieved of requirements that generate unnecessary bureaucracy and costs. The review of MiFIR offers an excellent opportunity to achieve this.

### *1. Market Transparency Bonds*

A bilateral transaction concluded directly between investment firm and investor is the traditional form of bond trading. Since this way of trading is associated with risks for the investment firm, only an appropriate level of transparency can help to make markets more efficient and maintain an equilibrium between supply and demand. It will be important, therefore, to strike the right balance between transparency and market efficiency. Too much market transparency in bond trading can make it impossible for investment firms to hedge the associated risk. This, in turn, has the effect of increasing the risk of liquidity being withdrawn from the market, thus decreasing the opportunities for investors to sell bonds in their portfolio on the secondary market, if necessary.

The possibility to defer post-trade transparency is, therefore, essential. While leaving the precise design of deferred post-trade transparency to national competent authorities (NCAs) has not proved successful, the legislative proposal of the Commission to change this is neither clear-cut nor sufficient.

We consider "ICMA's proposal for a new post-trade transparency regime for the EU corporate bond market"[1] suitable to achieve the much wanted market-sensitive harmonised rules across the EU. ICMA's proposal has the merit of i) being clear-cut, ii) being practicable and iii) representing an excellent compromise of – naturally – diverging views of the sell-side and the buy-side. Against this backdrop, we ask for a wording of Article 11 which would be suitable to incorporate the market-sensitive proposal of ICMA, including increasing the deferral period for both price and volume publication to a maximum of four weeks and introducing the amount outstanding as a proxy for liquidity determination.

### *2. Consolidated Tape*

From a market perspective, it is imperative to establish a tape for equity data first. This asset class contains the most liquid instruments that are traded most frequently. Equity trading data is as important for institutional investors as it is for retail investors. This demand for data should be satisfied as a priority. Guaranteed high-quality data are therefore the key to the success of a CT. The supply,

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[1] ICMA-position-paper-Proposal-for-a-new-post-trade-transparency-regime-for-the-EU-corporate-bond-market-December-2021-081221.pdf (icmagroup.org)

processing and dissemination of the data must meet highest quality standards. The quality assurance systems of the CT must be totally reliable to guarantee data excellence and dependable retrievability at all times. Moreover, it will be of utmost importance to ensure the same harmonised data format will be used for tape data and market transparency alike. Moreover, any sensible participation concept should ensure that all contributors are included in an objective and meaningful way. Such concept should ensure that all market data contributors get the chance to adequately participate in any distribution of revenues, be they large or small investment firms or large or small trading venues.

### *3. Transaction Reporting*

We support the idea to align the timing of changes in reporting frameworks, i.e. the date as of which new requirements effectively apply since it should help to smooth implementation The proposed amendment of Article 26 (9)(j) MiFIR, however, carries the risk of creating misunderstandings since it does not relate to changes in reporting frameworks but merely to "the date by which transactions are to be reported". The idea needs to be adequately reflected in the wording of the MiFIR.

## II. Specific comments on the legislative proposal for MiFIR

### *1. Market Transparency Bonds*

<u>Market transparency</u>

Investment firms which, either on own account or on behalf of clients, conclude transactions in bonds traded on a trading venue, must make public the volume and the price of those transactions through an approved publication arrangement (APA) before certain deadlines. Provided that a number of conditions are met, according to MiFIR the national competent authority may allow investment firms to publish certain details of a transaction or transactions at a later date and/or on an aggregated basis. There are good reasons for these provisions in Article 21 of MiFIR.

<u>No flow trading in bonds</u>

While flow trading is characteristic for the asset class equities, this does not apply to the asset class bonds. There are two main reasons for this. Bonds are typically subject to a buy-and-hold strategy, meaning bonds are predominantly acquired in the primary market, i.e. at issuance. In secondary market trading, i.e. during the term of the bond, turnover is often observed primarily in the days after the issue and at the end of the term. By using a buy-and-hold strategy, investors aim to achieve their return on investment through the interest payments which they receive during the term and the repayment of the bond amount at final maturity. Buy-and-sell strategies, which are typical in equity trading, are therefore not characteristic of bond trading. The second reason why flow trading is atypical for the asset class bonds is the far higher number of issues. While a public company typically has only one share, the same company can issue a large number of bonds. In the overall market, the number of bonds outstanding exceeds that of shares by a factor of 20 to 30. As a consequence, the available investment amounts are spread over a large number of bonds issued by the same entity, whereas with equity the investment volume is concentrated on one share.

<u>Balancing transparency and market efficiency</u>

When an institutional investor wants to sell an acquired bond during its term, the buyer will usually be an investment firm. In the event of a transaction, however, this investment firm will only want to take the position on its own books temporarily. Subsequently, the investment firm will try to unwind its position as quickly as possible by selling it to another institutional investor. This may take time, depending on the liquidity, it may take weeks or even months. If, against this backdrop, it must be assumed that the market will be informed at too early a stage about the trading interest of a market participant, this transparency will have negative repercussions on the price determination of the first transaction. The investment firm will have to ensure that any quote given adequately reflects the risks that it is about to take.

It will be important, therefore, to strike the right balance between transparency and market efficiency. Only an appropriate level of transparency can help to make markets more efficient and maintain an equilibrium between supply and demand. By contrast, too much market transparency in bond trading can make it impossible for investment firms to hedge the associated risk. This, in turn, has the effect of increasing the risk of liquidity being withdrawn from the market, thus decreasing the opportunities for investors to sell bonds in their portfolio on the secondary market, if necessary.

<u>Liquidity is crucial</u>
At what point in time a systematic internaliser has to make which transaction details transparent to other market participants depends mainly on the liquidity of the bonds in question, i.e. on whether a bond changes hands frequently or only rarely within a defined period. ESMA regularly calculates the liquidity of all outstanding bonds with the help of detailed parameters. In practice, ESMA only classifies a relatively small number of bonds as liquid – which ultimately reflects the nature of these financial instruments.

If the possibility of deferred publication does not exist, there are likely to be negative consequences for the efficiency of the financial market since information would have to be made public even if there was a significant risk of the market drawing the wrong conclusions and reacting disproportionately, which would undermine efficient price formation.

<u>Harmonised deferral regime – Necessary adjustments to the proposal</u>
Leaving the precise design of deferred post-trade transparency to national competent authorities has not proved successful, however. We therefore welcome the idea of introducing EU-wide harmonised rules for deferred post-trade transparency in bonds.

The legislative proposal of the Commission is neither clear-cut nor sufficient, though. The wording raises questions as to how the future regime should be understood. Firstly, we do not understand, how Article 11 (1) and Article 11(4) are meant to interact, if at all. Even more important is that the deferral options provided only partially meet the needs of the market. Finally, we propose to make deferrals for post-trade transparency in corporate bonds directly applicable in all Member States, i.e. without any necessity of national authorisation. This would bring about the desired effect of harmonised rules without detours and without granting discretionary powers to NCAs.

Therefore, clarifications to the proposed concept for Article 11 of MiFIR alone would not prevent a tightening of the market and/or a deterioration of prices since the concept does not cater sufficiently for liquidity providers', i.e. investment firms', needs to minimise their risks. Insufficient deferral options will not motivate investment firms to make liquidity available to the desirable extent. In tight markets, especially, there is a risk – with or without transparency – of the market drying up completely.

And it is not just illiquid instruments that would be affected, but financial instruments in general since the sell-side has to limit their risks in one way or another. Adequate deferral periods are needed to enable them to do so. And these should be the legal standard and not subject to discretion by the NCAs. We would also like to point out that the proposed changes to market transparency resulting from both options, i.e. price or volume deferral, would deliver no benefit to investors either.

With this in mind, we would like to express our support for "ICMA's proposal for a new post-trade transparency regime for the EU corporate bond market"[2]. ICMA's proposal has the merit of i) being clear-cut, ii) being practicable and iii) representing an excellent compromise of – naturally – diverging views of the sell-side and the buy-side. It would enable the sell-side, i.e. investment firms as liquidity providers to hedge their risks and serve the buy-side at the same time. As a consequence, it could be expected that market liquidity would not be critically affected.

To achieve this goal, the deferral period for both price <u>and</u> volume publication must be increased to a maximum of four weeks. The four-week period would be applied only to very large trades, but it is mandatory for these transactions.

We also agree with ICMA that the legislative proposal does not include a methodology for liquidity determination. The amount outstanding would be an excellent proxy for any bond's liquidity, i.e. bonds with an amount outstanding of at least 1 bln EUR would be considered as liquid and bonds with an amount below 1 bln EUR would be deemed illiquid. This proxy would be easy to implement and would also render ESMA's currently necessary calculations on a quarterly basis superfluous. This would save time and money for supervisors and investment firms alike without any negative consequences.

Against this backdrop, we ask for a wording of Article 11 which would be suitable to incorporate the market-sensitive proposal of ICMA. As the legislative proposal for Article 11 stands, it could be understood as if the Commission intends to establish a two-fold model. On the one hand, publication of the price of a transaction or of the volume can be deferred within certain limits (Article 11(1)). On the other hand, in Article 11(4) the proposal introduces three "buckets" to categorise bonds, i.e. with regard to liquidity, transaction size and ratings. It might make sense to amalgamate the meaning of Article 11(1) and Article 11(4) in one paragraph, incorporating a maximum deferral period for price and time of four weeks plus making these deferrals automatically applicable in all Member States without further necessity for national authorisation.

## *2. Consolidated Tape*

<u>Data quality is key</u>
Using a single data source could have numerous advantages if implemented correctly. It will therefore be crucially important that CT data can serve as a "golden source" for market participants. To achieve this, it has to be ensured that the data are of the highest quality. Guaranteed high-quality data are therefore the key to the success of a CT. The supply, processing and dissemination of the data must meet highest quality standards. The quality assurance systems of the CT must be totally reliable to guarantee data excellence and dependable retrievability at all times.

<u>Equity tape first</u>
From a market perspective, it seems imperative to establish a tape for equity data first. This asset class contains the most liquid instruments that are traded most frequently. Equity trading data is as important for institutional investors as it is for retail investors. This demand for data should be satisfied as a

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[2] ICMA-position-paper-Proposal-for-a-new-post-trade-transparency-regime-for-the-EU-corporate-bond-market-December-2021-081221.pdf (icmagroup.org)

priority. One could start with post-trade data, but pre-trade data is likely to be of at least as much interest. With regard to a bond tape, ESMA should assess market demand first and look at both costs and benefits to provide a proper basis for decision. The same goes for a tape for derivatives which would be even more complex to be established in a meaningful way

Multi-purpose harmonised data formats are essential
Investment firms have to make public post-trade transparency data via an approved publication arrangement (APA). The APA in turn shall act as a market data contributor vis-à-vis the CTP. It will be of utmost importance to ensure that the same harmonised data format will be used for both purposes. Therefore, the Level 1 text ought to make clear that ESMA shall develop draft regulatory standards accordingly.

CT selection process and revenue sharing
Article 27da(2) of the proposal contains ten criteria for ESMA's assessment of applications for CTPs. This list does not include quality aspects. Since data of the highest quality will be the key to a successful CT, this criterion must be added. Additionally, it must be specified, that data quality refers to the prescribed content, format and punctual contribution of data. All three components are essential for a successful CT.

Article 27da(3) of the proposal states that ESMA shall, when considering the competing tenders for the CTP, select the CTP for shares that offers the revenue participation scheme which provides regulated markets, in particular smaller regulated markets, with the highest amount of revenue. Firstly, the concept of limiting the distribution of revenue to smaller regulated markets discriminates other market data contributors in a highly unfair manner. Secondly, the prioritisation of the criterion "revenue participation scheme" would render the remaining nine criteria meaningless.

Against this backdrop, we firstly suggest to substitute the proposed selection concept by a concept which ensures that all market data contributors get the chance to adequately participate in any distribution of revenues, be they large or small investment firms or large or small trading venues. Any sensible participation concept should ensure that all contributors are included in an objective and meaningful way. A degressive approach, for example, would mean that the remuneration amount per data-set decreases with the number of submitted data-sets.

Secondly, it must be ensured that all ten selection criterion play a meaningful role in ESMA's selection process. Due diligence should be applied when weighting these selection criteria.

Good governance includes CT users
The success of the CT stands and falls not only with the data quality, but also with the quality of the governance model. We believe a balanced representation of all users will be essential. This means, in particular, that data users should also – and especially – have a say in decisions on cost structures.
It must be ensured that any body representing the stakeholders is set up in a transparent manner. The currently foreseen approach to set up an expert stakeholder group (Article 22b(1)) is not sufficient. It neither ensures that all stakeholders would be involved, nor does is make clear how the advice of this group would be incorporated into the delegated acts to be adopted by the Commission. In addition, the mandate of this group is too narrow due to the limitation to data quality. The mandate should encompass all relevant aspects, including costs, data quality, technical aspects of the tape etc.

In addition, we believe it is necessary to involve the market as a whole via consultations. This is the only way to ensure that all material aspects can be adequately taken into account in the legislative process.

### *3. Transaction Reporting*

<u>Alignment of timing of changes in reporting frameworks</u>
We understand from Recital 18 that the Commission aims to align the timing of changes in reporting frameworks, i.e. the date as of which new requirements effectively apply. While we support this idea since it should help to smooth implementation, we would like to point out that this idea should be adequately reflected in the wording of the MiFIR. The proposed amendment of Article 26 (9)(j) MiFIR, however, carries the risk of creating misunderstandings since it does not relate to changes in reporting frameworks but merely to "the date by which transactions are to be reported".

Although the proposed wording in the legislative proposal seems to be derived from EMIR, it is bound to be misunderstood. Art. 9 (6) (d) EMIR reads as follows:

"*d) the date by which derivative contracts are to be reported."*

However, the original wording of this paragraph was the following:
*"the date by which derivative contracts are to be reported, including any phase-in for contracts entered into before the reporting obligation applies."*

This seemed reasonable at the time since, until then, derivatives reporting did not exist. The trade repositories (TR) had to be set up first and accordingly EMIR provided that derivative contracts had to be reported after admission of a TR and not primarily as of any fixed date in EMIR. In addition and different from MiFIR reporting ("transaction reporting"), reporting under EMIR is an ongoing reporting ("position reporting"). Changes in the market price also have to be reported. Therefore, in the EMIR context, such provision might be necessary and meaningful. However, this wording did not prevent that amendments to EMIR according to the EMIR Refit which needed clarification in delegated acts entered into force before the delegated acts (level II) were even drafted. Hence, such drafting has proven as not being fit for purpose.

In order to avoid any misunderstandings and to ensure that amendments in Level I enter into force at the same time as the corresponding Level II requirements we would propose an amendment to Art. 55 MiFIR. There, it could be specified that *the requirements under Art. 26 (1) through (8) shall apply from the date of entry into force of the delegated act adopted by the Commission pursuant to 26 (9)*.

This way it would be ensured that requirements under Level I and II apply as of the same date. Also, by delegating the actual application of the rules to the delegated act on level II, ESMA and the Commission could also cater for an alignment of changes in different reporting frameworks.

### *4. Payments for Order Flow*

We understand that the current wording of Art. 39a MiFIR addresses issues of the secondary market. Therefore, we suggest narrowing down the wide wording of Art. 39a of Draft MiFIR for this purpose.

In general, we do not see an issue with payments for order flow that need to be regulated. MiFID II already offers a broad toolkit of regulatory measures in this respect which, in our view, need to be enforced in case of any potential compliance shortcomings before any new regulatory measures will be introduced. Taking into account the principle of proportionality, a general ban on certain practices should always be ultima ratio. Therefore, we suggest analyzing the situation in detail and gathering further evidence in order to decide on an appropriate measure on this basis.

## III. Further necessary adjustments

### *1. Definition of systematic internalisers (SIs)*

Re-launch of the MiFID I definition of systematic internalisier (SI) and introduction of a designated reporting entity
MiFID I introduced the definition of a systematic internaliser (SI). That definition required investment firms to be classified as SIs if they dealt on their own account when executing a significant proportion of client orders for shares. Since then, SIs in shares have been subject, in particular, to certain pre- and post-trade transparency obligations.

Under MiFID II, the SI rules were extended to trading in non-equity instruments (bonds, derivatives). In addition, thresholds were set which, if exceeded, automatically lead to investment firms being classified as SIs. Investment firms that trade on their own account in these instruments must therefore regularly perform complex calculations to determine whether or not they qualify as an SI. These calculations are made on the basis of extensive data collected by ESMA. Alternatively, investment firms can opt to be treated as an SI. In both cases, they are subject to extensive follow-up requirements, especially market transparency obligations.

One of the main reasons why firms decide to 'opt-in' to the SI regime, however, is the ability of SIs to report trades to the market via an approved publication arrangement (APA) on behalf of their clients. While this possibility should continue to exist, it should be decoupled from the SI status. Instead, the concept of a 'designated reporting entity' should be introduced.

What is equally important is for EU lawmakers to reinstate the MiFID I definition of systematic internaliser. This would bring considerable relief to both ESMA and investment firms. The resources thus freed up could be put to a more sensible use. To ensure a level playing field in the EU27, the consistency of supervisory practices should be a top priority.

Not only would this eliminate the need for both supervisors and investment firms to perform complex calculations, thus reducing the time, effort and expense involved. In combination with the concept of a 'designated reporting entity' it would ensure that only investment firms who act as SI would be qualified as such.

### *2. Systematic internalisers in bonds*

Treatment of illiquid bonds
Article 18(2) of MiFIR regulates trading in illiquid non-equity instruments. The obligation for SIs to disclose quotes to their clients may be waived where certain conditions are met. We would even recommend to delete Article 18(2) of MiFIR. Illiquid instruments require special treatment as inappropriate market transparency has damaging effects on such instruments. It is important to avoid trading in illiquid bonds drying up altogether because investment firms are unable to bear the increased risk arising from transparency requirements. The best way to avoid negative reactions would be to exclude all illiquid instruments from pre-trade transparency obligations.

Limit pre-trade transparency to the client who prompted the quote
We recommend to delete Article 18(5) of MiFIR as the prescribed pre-trade transparency to (all) other clients unduly increases risk for SIs.

No obligation to trade up to the size specific to the instrument (SSTI) threshold
As a fundamental matter of regulatory principle we oppose any form of obligation to enter into a contractual agreement. On top of that, the requirement under Article 18(6), subparagraph 1 of MiFIR to enter into transactions with all interested clients on the same conditions has proven unfit for purpose as it exposes SIs to unreasonable risks, which they can only mitigate by adjusting their conditions – ultimately to the disadvantage of the investor. Therefore, we recommend deletion of Article 18(6) of MiFIR.

No limits on the number of transactions (Article 18(7) of MiFIR)
Finally, we recommend deletion of Article 18(7) of MiFIR as a necessary follow-up to the deletion of Article 18(5) and (6) of MiFIR.

Size specific to the instrument (SSTI) is vital for systematic internalisation in bonds
We support the goal of streamlining and harmonising market transparency obligations provided that no collateral damage to market participants is caused. We notice that the legislative proposal intends to remove the SSTI waiver to deferred publication of non-equity (Article aa(1)(c) of MiFIR). Concerning other areas, however, we would like to emphasise the fact that the SSTI criterion plays a major role in systematic internalisation in bonds: Article 18(10) of MiFIR stipulates that all other provisions of Article 18 apply only to trades below the SSTI threshold. A removal of the SSTI with regard to Article 18 MiFIR would have negative consequences which should be avoided by any means. We therefore warmly welcome that the legislative proposal with regard to the removal of the SSTI is limited to deferred post-trade transparency.

### *3. OTF operation and systematic internalisation by the same legal entity*

Organised trading facilities (OTFs) are trading venues, though limited to trading in non-equity instruments. An OTF can be operated by an investment firm, but not if it simultaneously acts as an SI within the same legal entity. This restriction is intended to avoid conflicts of interest but represents a high barrier to market entry as two legal entities are needed if an investment firm wants to offer both types of trading.

The EU regime should allow the same legal entity to operate an OTF and act as an SI in order to remove this obstacle to market entry for investment firms. Any conflicts of interest can be managed through appropriate organisational arrangements.

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