A review of MiFID II and MiFIR

Impact on the fixed income and derivative markets

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The Dutch Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

Recommendations and Executive Summary

The AFM has performed an in-depth analysis of the fixed income and derivatives markets as part of its internal MiFID review. For the markets in fixed income instruments and related derivatives, the introduction of MiFID II constituted a major reform of existing market practices. For the AFM, the growth in fixed income trading volumes resulting from the relocation of parts of the London-based fixed income trading infrastructure created a significant broadening of its supervisory focus. This has prompted us to use the MiFID II review as an important tool to understand the fixed income market characteristics, as well as to provide a broader strategic vision based on the AFM's perspective on the merits of transparent multilateral markets.

In this context, we propose the following recommendations to address the fundamentals of the fixed income market structure, combined with targeted amendments to a range of MiFID and MiFIR provisions.

Key Recommendation – Address the Fixed Income Market Fundamentals:

The AFM aims to initiate a broader review of the fixed income market structure with market and industry stakeholders on the following topics:

Primary Market Structure

- A broader assessment of the role of primary dealers and a deeper review of existing mechanics around issuance, underwriting, distribution and liquidity provision;
- How to include non-bank participants in the issuance, underwriting, distribution and liquidity provision process for both government bonds (DMOs) and corporate (issuers);
- How to create incentives for issuers and dealers to broaden liquidity provision requirements and quoting obligations across multiple types of platforms (in the interdealer market).

Incentives for increasing instrument standardization

- The AFM is of the opinion that the MiFID II goals of transparent fixed income markets can best be realized by stimulating a standardization of issuance practices and by reducing complexities for eligible instruments and issuers. This requires a concerted effort between market participants, issuers and the regulatory community.

Specific recommendations related to the review of MiFID/MiFIR

Recommendations to increase the level playing field:

- To protect the integrity of the European capital markets and prevent regulatory arbitrage, Article 1.7 of MiFID should be added to the MiFIR to ensure regulatory clarity on the definition of multilateral trading systems.
- The AFM endorses more supervisory convergence around the enforcement of MiFID Article 1.7. on the scope multilateral trading systems at ESMA level.

- To ensure orderly markets and protect the level playing field with multilateral trading venues, Systematic Internalisers should be included in the MiFID algo trading requirements by adjusting Article 17 of MiFID II to include algorithmic OTC trading.

Recommendations to reduce complexity and focus on achieving meaningful transparency

Fixed income transparency

- Given the characteristics of the fixed income markets, types of participants and the bespoke nature of such instruments, we believe there is very little added value in pre-trade data that cannot be used for price discovery or for obtaining a consolidated market view. The AFM recommends removing illiquid non-equity instruments from the scope of pre-trade transparency.
- In order to ensure a consolidated market view, increasing the level playing field with access to information and a concentrated effort on improving overall data quality, the transparency focus should shift to liquid instruments with post-trade transparency as close to real-time as possible.
- Once data quality is improved on this basis, a logical next step is that market visibility could be further improved by the introduction of a post-trade consolidated tape (CTP) containing basic information such as price, size, trading venue, volume, timestamp of execution, yield and tenor.
- In addition to reducing the transparency scope, the AFM also believes that to ease resources, reduce the data burden and realign efforts within secondary markets supervision, fixed income instruments that are illiquid for transparency purposes should no longer be required to provide an instrument identifier based on the Instrument-by-Instrument (IBIA) approach. Rather, an ID of the (illiquid) class of financial instruments should suffice (COFIA).
- Given the rather uniform requirements of data handling and report querying, large costs savings could be achieved with data quality supervision and application development at EU level. This could be achieved by consolidating data collection at ESMA level through a centralized depository. This would converge data standards, reduce redundancies, and capture economies of scale and lower supervisory costs across the EU.

Specific recommendations for the OTC derivative markets

- The AFM recommends expanding the Derivative Trading Obligation (DTO) by aligning the separate liquidity assessment of the DTO with that of the MiFIR transparency assessment. This reduces complexity, broadens the scope and strengthens centrally cleared and transparent derivatives markets.
- We see merit in expanding the scope of OTC derivative instruments in scope of the Traded on a Trading Venue (ToTV) methodology for post-trade transparency purposes, particularly for OTC derivative transactions involving a systematic internaliser as counterparty.
- The AFM would also invite ESMA and other stakeholders to consider expanding the scope of the EMIR clearing obligation towards foreign exchange (FX swaps and forwards) and commodity derivatives that are cash settled.

1. Executive Summary

Overall, the main objective of MiFID II in the fixed income markets was to increase transparency and competition by moving the still largely OTC fixed income markets towards a structure that has more similarities with the equity markets. This was the result of the post-crisis G20 commitments in 2009.

In order to create a more transparent mechanism for price discovery, the intention was to encourage execution of fixed income trading via regulated markets, Systematic Internalisers, OTFs and MTFs, as well as aligning fixed income instruments with MiFID's pre- and post-trade transparency requirements. As a result, the requirements have affected nearly all aspects of the secondary market structure and the manner in which fixed income products are marketed, traded and reported.

In this context, it is important to consider the new requirements in the right perspective. Given the specific characteristics of these markets, the diversity of asset classes covered, existing trading protocols and lack of standardisation, MiFID II offered a wide range of exemptions and waivers for the requirements based on the liquidity of the in-scope product. While MiFID II has strongly amplified the existing trend of electronifcation of fixed income trading protocols towards platforms, only a small fraction of the EU fixed income market has become subject to the requirements on transparency and on-venue trading, despite initial concerns voiced by market participations prior to the entry into force. This is demonstrated by the fact that around 96% of the trading in bonds benefits from waivers and deferrals from transparency, mainly as a result of lack of liquidity of the instrument.[1]

In general, we note that the overall sentiment is that MiFID II has not yet delivered on its goals in the fixed income markets and can still be considered work in progress. The main finding is that MiFID II's focus on transparency based on liquidity has proven to be counterproductive given the lack of liquidity in the fixed income markets where most instruments are tailor-made and not designed to be traded on a secondary market in the first place. This view is echoed by market participants who argue that MiFID II has merely sought to replicate equity market conventions onto so-called "non-equity" segments and that enforcing transparency on such markets is counterproductive. Instead, it can be argued that sufficiently liquid fixed income markets in which higher levels of transparency are sustainable, can only can be achieved by incentivizing standardization of instruments and addressing primary market fundamentals.

Overall, there is still broad support for the original G20 goals of migrating fixed income markets and derivatives towards more transparent and open markets. At this stage, MiFID II can be considered unfinished business and requires action from regulatory authorities to ensure it reaches its goals.

[1] https://www.esma.europa.eu/press-news/esma-news/mifid-ii-esma-makes-new-bond-liquidity-data-available-6

Besides the goal for addressing market fundamentals through creating incentives for more standardization, this review provides a number of concrete recommendations for improving the level playing field between bilateral and transparent multilateral forms of trading by creating more regulatory certainty. In addition, the right conditions for meaningful transparency can be achieved by focusing on improving data quality through an enhanced focus on liquid instruments, as well as the introduction of a post-trade consolidated tape.

2. Introduction and general review findings

After the financial crisis of 2008, it became clear that wide ranging reforms were necessary for the fixed income and derivatives markets. At the G20 level in 2009, it was agreed that these markets would be subject to stricter regulation in order to increase transparency.

In the EU, the G20 objectives for derivatives and fixed income became part of EMIR and MiFID II. In the case of MiFID II, the main structural reform for the non-equity segment was the introduction of a licensing requirement for all “multilateral systems” and a new concept of an Organized Trading Facility (OTF) and the introduction of pre- and post-trade transparency requirements.

To further push trading towards regulated third party platforms, the derivative trading obligation (DTO) was introduced for the most liquid derivatives. These instruments were only to be traded through transparent and centrally cleared multilateral trading models. The remaining instruments were allowed to remain bilateral, but were made subject to transparency requirements to level the playing field with trading venues (the ToTV concept).

MiFID II also leveled the playing field between trading venues with requirements for open access. Its broader aim was to break up the traditional trading and clearing monopolies by incumbent exchange groups and remove barriers to entry. In that same spirit, restrictions were introduced for the fees that trading venues could charge for data. Such market data is highly valuable as it allows investors to assess the price and quality of the trade execution services offered by the sell-side. To further support competition and such data assessments, both brokers and trading venues were mandated to provide quarterly best-execution data-analyses.

In the report below, you will find the conclusions of the AFM’s review based on the current state of implementation and functioning of MiFID II in the fixed income market and its derivatives. These findings are primarily based on AFM supervisory experience supplemented with desk research and bilateral discussions with market participants as well as a round table meeting with key stakeholders in the fixed income market.

General review findings

In general, we find that the overall sentiment among market participants in the fixed income markets is that MiFID II has not yet delivered on its goals. Feedback includes the observation that MiFID II transparency has done nothing but raise the costs of doing business, while bid/offer spreads in the fixed income markets are perceived to have deteriorated. Despite all efforts, the fixed income markets are still considered to remain closed to non-bank participants, with little meaningful transparency and high costs of execution. The withdrawal of liquidity providers from this market is largely blamed on changes in capital requirements that have made holding trade-inventories more expensive for market makers. The general idea is that MiFID II transparency requirements have made things worse in the bond market.

The same sentiment dominates the image of MiFID II in the interest rate derivatives market, although the tone there is a little more positive. This is for a large part due to the EMIR clearing obligation (CO), which is believed to have stimulated the trading of derivatives on trading venues and especially buy-side firms are pleased with this development. In a similar line of thought, many market participant also credit MiFID II for providing the incentive to standardize administrative processes and migrate from paper and voice to electronic execution methods. In addition, MiFID II is often credited with having increased awareness on the costs of execution (best execution) at buy-side firms.

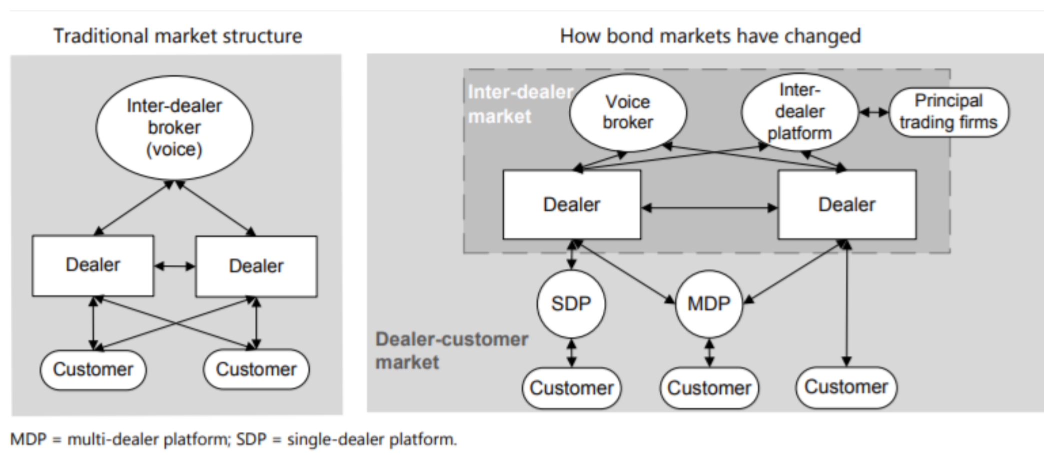
While the overall sentiment about MiFID II is relatively negative, we find that there is still general support for the original G20 goals of migrating fixed income markets and their derivatives towards more transparent and open markets. MiFID II transparency is considered unfinished business and requires action from regulatory authorities to ensure it reaches its goals.

Before we elaborate on the more specific findings and recommendations, it is important to examine a recurring more fundamental argument of critique on MiFID II. This is, as market participants often stress, the point that current fixed income instruments and their derivatives are not designed to be traded in secondary markets. They claim MiFID II is an unintelligent copy-paste of equity market conventions onto so-called “non-equity” and that enforcing transparency on such markets is counterproductive. Instead, many argue that sufficiently liquid fixed income markets in which higher levels of transparency are sustainable, can only can be achieved with more standardized instruments.

3. Market structure and changes in the fixed income markets: impact on trading practices and secondary market liquidity

With regard to the secondary market for fixed income products, this market has traditionally been dominated by a strong bilateral relationship model between sell-side dealers and buy-side clients. Trading in fixed income instruments is characterized by different trading and execution methods, depending on the type of end-user. The dealer-to-client (D2C) market is a model characterized by large banks acting as both dealers and market makers, allowing buy-side clients and end-users to trade in tailored size positions. This method relies on a bilateral model for both price discovery and execution through a request for quote (RfQ) setup. In general, the D2C market's main trading models are a.) voice/telephone, b.) single-dealer platforms operated by banks/broker dealers (acting in the form of systematic internalisers), or c.) multi-dealer platforms where liquidity is provided by multiple market makers. A relatively recent model is the multilateral all-to-all platform that allows buy-side firms to trade with each other through a Central Limit Order Book (CLOB). Market participants have also cited the emergence of hybrid models such as on-venue protocols, where trades are agreed bilaterally and subsequently executed on a platform. The dealer-to-dealer (D2D) segment is largely bilateral or operating through interdealer broker platforms.

Figure 1: The evolving fixed income market structure

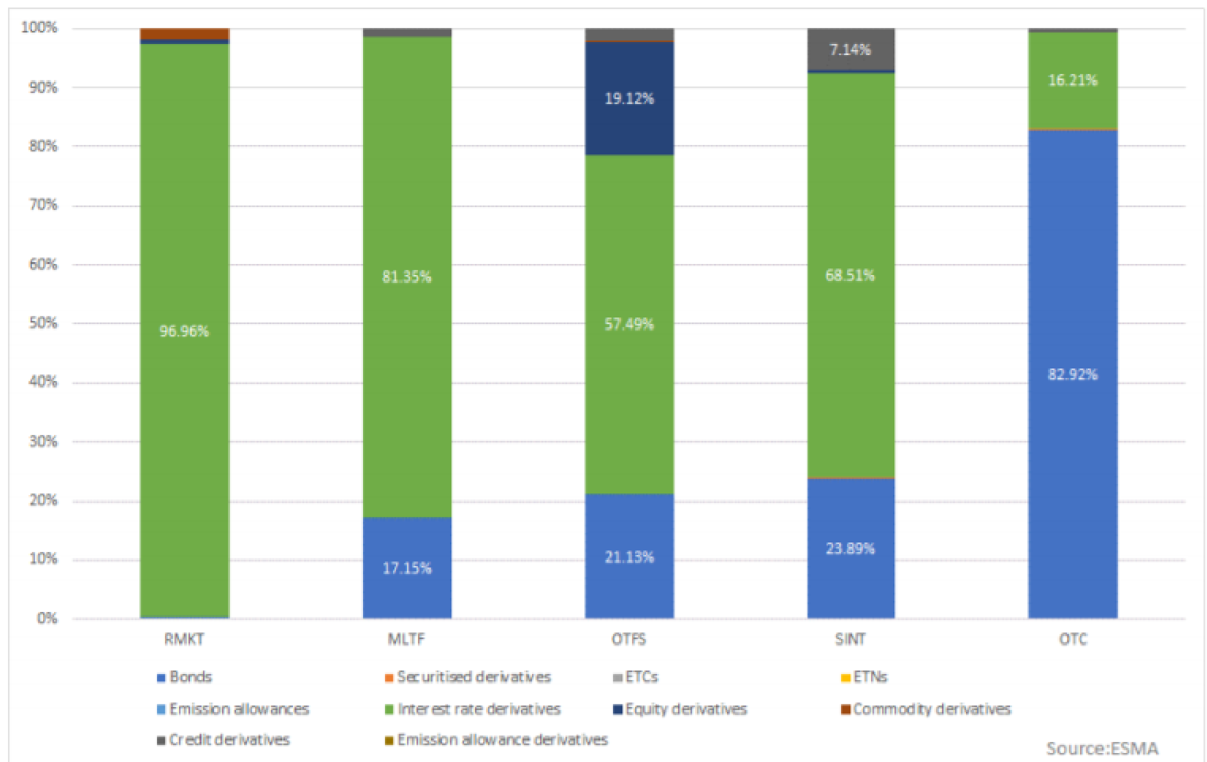


Source: Bank for International Settlements – Electronic trading in fixed income markets (January 2016)

The overall picture that emerges based on our research and feedback from market participants is that the fixed-income markets are moving away from voice driven transactions towards execution on more organized (multilateral) trading systems. Market participants underline that this development is not the direct result of MiFID, but rather part of a further trend towards electronic trading where technology has made it easier to have access to multiple counterparties. It is argued that it has become easier to find liquidity, but it has not increased the overall size of liquidity (nor the need thereof) in the fixed income market *per se.* It is also noted that mainly smaller tickets have

shifted towards trading platforms, while larger size tickets are still based on existing OTC broker relations. (see Figure 2 below) This allows end-users to execute such positions without causing price volatility, particularly in the case of illiquid or less standardized instruments. For this reason, MiFID already provides for a wide range of waivers and deferrals for pre-and post-trade transparency. (This is discussed in more detail in the next paragraph)

Figure 2 Notional amount in non-equity instruments per execution venue, per asset class, 2018



Source: ESMA - MiFID II/ MiFIR review report on the transparency regime for non-equity instruments and the trading obligation for derivatives (March 2020)

However, to understand the current stage of the secondary markets in fixed income instruments, particularly in relation to transparency and multilateral forms of trading, it is necessary to understand the role of the primary markets in fixed income and the main considerations for issuing an instrument.

The primary market is often referred to as the "new issues" market in which transactions occur directly between the bond issuers and the bond buyers. It is not until instruments are issued in the primary market that the secondary market comes into play as the platform where other investors can purchase these bonds from primary market buyers and allows buyers to re-sell the instruments.

Why the primary markets matter

One of the main characteristics of debt finance, both in bank as well as in the issuance of fixed income instruments, is the fact that terms (i.e. diversity of tenors, structures, conditions, covenants, currencies and timing) are fully negotiable and customized to the issuer's needs.

This is a fundamental difference compared to the equity markets as the very nature of fixed income instruments relates to its bespoke and tailored terms.

To understand the role of the primary markets in fixed income and the implications on secondary markets, we have to take the following considerations into account:

- Differences between instruments types, most notably between government bonds and corporate bonds;
- Rating of the issuer;[2]
- Reasons for issuance of new instruments;
- The role of primary dealers, banks and syndicates in the entire instrument's lifecycle, creating an odd blended form between bank and market financing;
- Regulatory requirements of new issuances;[3]
- Central bank monetary policy;
- The impact of capital requirements and reduced balance sheet capacity for dealers;
- Barriers to entry for non-bank participants and lack of a level playing field.

We believe these factors all contribute to an overall lack of incentives to make instruments eligible for secondary market trading, sometimes for good reason. In some cases, it leads to barriers in the realization of the full economic benefits of the secondary market and would partially explain the current stage of the secondary markets. This is addressed further below.

The role of dealers and agents in relation to secondary market liquidity

Traditionally, the fixed income markets have been characterized as primary markets where principal dealers have multiple roles as both underwriter of new issues and market makers for newly issued instruments, as well as offering brokerage and order execution services whilst distributing instruments to clients and end investors. These broker-dealers are mostly merchant banks that act in syndicates of multiple institutions.

Dealers that are underwriting a new issue typically take a significant amount of these instruments on their balance sheet ("warehousing") and sell these to their large relationship-based institutional clients, such as pension funds and asset managers or to other dealers. Since instruments are often not listed on a central exchange (as is the case with the issue of equity instruments), price

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[2] For example, investment grade refers to bonds or companies with a rating indicating a relatively low risk of default, as opposed to high yield bonds, characterized by higher risk and higher potential return. Investment grade encompasses high credit quality ratings ('AAA' and 'AA') and medium credit quality ratings ('A' and 'BBB')

[3] In the EEA, the Prospectus Regulation sets the framework for disclosure requirements for issuers markets. Issuers have to draw up and file a prospectus with the relevant NCA, describing in detail the activities of the issuer, its financial situation, risk factors and prospects. The prospectus requires approval from the NCA and has to be published prior to the issuance.

information is highly decentralized and limited to quotes provided to a select group of investors. The broker-dealer generates its income mainly on the bid-offer spread. These can be wide as the sale of these instruments requires a fair amount of intermediation costs and strongly depends on the characteristics of the bond, rating of the issuer, tenors and overall market conditions. Such market making broker-dealer banks also incur a potential conflict of interests as they have to take principal risk while at the same time having to off-set their client's positions in order to manage their balance/sheet and inventory.

The second type of primary market participants are agents that act as brokers only and receive compensation for their intermediation from (buy-side) clients. Agents do not use their balance sheet for warehousing purposes, but will require some degree of information on prices and volumes in order to service their clients and would benefit from sufficient transparency. Increasingly, in the US market both specialized independent dealers and agents are able to participate in the primary markets where they are able to act as market makers and also underwrite new issues. This is not yet the case in Europe.

How instruments are issued

New issues can generally be done in three ways. The most common method is through a syndicated issuance (usually done by multiple investment banks) allocating new instruments to other dealers and buy-side investors. Short term investors will immediately seek to sell these bonds in the secondary market. Such newly-issued instruments are referred to as *on-the-run* bonds and are generally liquid for a short period of time. Long-term investors will usually hold the bonds to maturity.

The second way in which bonds are issued is through private placements. In a private placement, dealer banks will contact investors directly. These investors are generally the most sophisticated players, and bonds issues in private placement are usually tailored instruments that are not eligible for trading in the secondary markets. A notable exception is the retail segment of the Italian government bond market where retail investors can directly participate in private placements, using secondary market infrastructure largely similar to that of equity markets.

A third method applies specifically to government bonds. Most government bonds are auctioned by national debt management offices (DMO) on a periodic basis to designated primary dealers. (These differ per jurisdiction) Primary dealers buy government bonds directly from the DMO during the auction and sell them on to investors. This typically includes the obligation to maintain secondary market trading activity, which entails holding some of those bonds on their balance sheets for a period and selling bonds in the dealer-to-dealer and dealer-to-client segments.

Over the last few years, the traditional bank based broker- dealer model has started to shift. Since the financial crisis and subsequent regulatory reform, banks have been increasingly constrained in using their balance sheet as a result of stricter capital and liquidity requirements, particularly as a result of Basel III (implemented in the EEA as CRD/CRR). This makes inventory holding /warehousing more expensive given the required capital and balance sheet constraints, reducing a bank's ability to maintain large inventories of bonds, act as market maker and provide liquidity. This in turn

affects the return on capital for market making that needs sufficient scale in order to generate a profit. As a result, the appetite to act as market maker is decreasing. Combined with earning models of banks already under pressure, as well as the high costs base of maintaining trading desks, a number of banks have started to significantly decrease their market making activity or have ceased such activities altogether. We understand that smaller dealers in particular are leaving the market given the balance sheet and capital cost impact, as well as the need for technology upkeep for information consolidation and execution purposes.

The changing role of banks significantly affects liquidity provision in the fixed income markets, which is a void that has not yet been filled by non-bank entities. At the same time, the primary market remains closed and unattractive for non-bank participants or more agency-type intermediaries that could be willing to underwrite new issuances and provide liquidity.

Specific characteristics of the corporate bond primary markets

Paradoxically, while banks have been increasingly reluctant to act as market maker and underwrite new issues, the corporate bond market in Europe has more than doubled in the last decade. Benefiting from a low interest rate environment, corporate bond issuances are now a significant source of financing for companies.

A distinct and justified feature of corporate bonds is that issuers issue bonds to seek a tailored match between their financing needs (i.e. to build a factory), terms of the issue and subsequent maturities, as well as the type of (buy-side) investors interested in those instruments. The illiquid nature of corporate bonds therefore lies in their bespoke nature as either: 1.) a company issues a bond for very specific financing needs, 2.) undertakes several bond issues as part of its (re)financing/funding mix (where it needs to continuously replace those that mature on an ongoing basis) or 3.) it does so when it sees favorable market conditions.

This leads to a situation where issuers have large numbers of bonds outstanding with different maturities and characteristics, making them less suitable for active secondary market trading *by nature* given their lack of convergence compared to when a company would simply issue stock. It also leads to fundamental market (data) quality questions given the large numbers of individual instruments outstanding in terms of convergence, achieving a consolidated market view, accurate pricing and aggregation of data for transparency purposes. This is discussed later in the document.

In many cases, after issuance many corporate bonds get "silo-ed" in portfolios of buy and hold investors to maturity (i.e. pension funds) or have been bought by central banks as part of asset purchase programs. Active secondary market trading in corporate bonds will generally only take place in the weeks or days after issuance or when the issuer has a credit event (such as, for example, a credit rating downgrade or adverse publicity). Upon expiry, the bond is either refinanced or it simply matures. As a result, secondary market liquidity of corporate bonds is generally low and less attractive for non-bank participants or more agency-type intermediaries. Creating the right incentives for secondary market trading for such instruments remains difficult.

Key Recommendation 1:

The AFM sees room to further commence a discussion on primary market fundamentals with market stakeholders, including but not limited to:

- **A broader assessment of the role of primary dealers and a deeper review of existing mechanics around issuance, underwriting, distribution and liquidity provision;**
- **How to include non-bank participants in the issuance, underwriting, distribution and liquidity provision process for both government bonds (DMOs) and corporate (issuers)**
- **How to create incentives for issuers and dealers to broaden liquidity provision requirements and quoting obligations across multiple types of platforms (in the interdealer market)**

Transparency is the consequence of liquid markets, not the cause.

As described above, in the traditional equity markets, liquid transparent secondary markets have developed around a practice of pooling all equity funding in a single and fungible instrument. This standardization and/or commoditization created the conditions that allowed the transparent all-to-all central limit order book (CLOB) markets to prosper. In contrast, most debt funding by corporates and sovereigns is generally spread over a multitude of illiquid instruments. Furthermore, not all debt issuers are interested in secondary market liquidity at all, given the high demand for fixed instruments by (buy-and-hold) investors and central bank bond purchasing programs.

As a result of the very nature of fixed income instruments their secondary markets are inherently illiquid. Transactions in such instruments are complex and price discovery is difficult. This means that trades can almost only be executed in larger tranches in a closed network of trusted institutional counterparties (and i.e. not with retail or semi-professional entities) using specific protocols. In such markets, simply increasing transparency for all would be counterproductive as it reduces incentives for market makers to provide liquidity because transparency exposes them to the undue risks, such as front running. At the same time, the even less transparent OTC/Voice trading space remains a full-fledged alternative. This raises concerns on whether enforcing further transparency of on-venue traded fixed income instruments would be counterproductive and would instead incentivize OTC trading.

The case for increased standardization

The AFM believes there is a strong case to be made for viable, transparent and liquid secondary fixed income markets, particularly in the corporate bond market. Liquid and transparent secondary markets act as an important price reference for issuers and investors alike, leading to lower funding costs and making new issuances easier. Rather than the current focus of balancing transparency requirements with waivers and deferrals to protect liquidity, we believe that the primary market fundamentals must be addressed in order to increase secondary market liquidity and subsequently allow for higher levels of transparency. This would primarily apply to corporate bonds, where we believe more standardization to improve instrument fungibility would lend itself to instruments

issued for general funding purposes rather than tailor-made instruments. Such standards would aim to lower the costs of secondary market liquidity and increase investor protection through higher levels of transparency.

To encourage standardization of such instruments, it makes sense to stimulate markets to align issuing practices. For general funding purposes of individual (investment grade) corporate issuers, the most straightforward approach would be to better align issuances and maturities based on standard terms and regular intervals, including issues in lower minimum denominations/sizes targeting retail investors. This could be incentivized by allowing eligible instruments and issuers to go through a simplified-regulatory approval processes for each new issuance. A clear example of such an approach is the European Commission's proposal for a short-form EU Recovery Prospectus for existing issuers seeking to raise new capital.[4] The validity of the prospectus of such a program could also be extended.

Secondary market liquidity would improve because of the increased amount of fungible instruments, larger total sizes per issue and a more efficient price discovery process of not having to study the small print of each traded instrument. This should be combined with lower market access barriers attracting a broader range of investors and market participants. Further standardization would also make it attractive for non-bank dealers to participate in bond issuance and underwriting. This would increase the level playing field between various types of market participants and reduce dependency on banks.

Secondly, large institutional players have long pointed out that there is a worrying gap between supply and demand for standardized instruments. A market response has been the sharp increase in fixed income ETFs. At the same time, the strong retail demand for ETFs and the growth in passive investment strategies by asset managers has been insufficiently recognized as such by corporate issuers. This is currently leading to a liquidity mismatch with underlying securities in fixed income. One of the consequences (as demonstrated during the Covid-19 crisis) is increased volatility in EFP (exchange for physical) premiums, i.e. the difference between the price of the instrument and the net asset value (NAV) of the benchmark portfolio. The availability of fungible and liquid instruments would potentially reduce this need to create alternative instruments such as ETFs in order meet investor demand for fixed income products.

Another reason why standardization incentives have been dampened relates to the current monetary policy stance. By effectively creating subsidies and cheap loans through asset purchase programs, monetary policy enables commercial banks to retain retail savings by offering rates way above the (negative) market yield. This has reduced incentives for issuers to target retail savings and collect the liquidity premium that is normally available through standardization.

Lastly, we also understand that excessive disclosure requirements/red tape for bond issuances assure that in many instances bank loans can offer cheaper sources of financing and stimulate the growth of private equity. The relative underdevelopment of (corporate) bond markets at national

[4] https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-536-F1-EN-MAIN-PART-1.PDF

and/or European level, as well as the European corporate culture which traditionally relies more on bank funding and institutional relations than on competitive capital markets is another explanation hampering further development of both primary and secondary corporate bond markets. Given the double role and interests of banks as the dominant type of dealer and loan provider, a picture emerges where banks have strong skin-in-the-game in both the European corporate loan market and the corporate debt market. These potentially conflicting interests are also often pointed at as obstacles for a natural transmission between supply and demand of standardized issuance practices. Given the need for tailored instruments, a situation has arisen where banks play multiple roles in design, pricing and distribution that is known to give rise to moral hazard and potential anti-competitive behavior. We believe this a key barrier in the development of further market-based financing and the vital diversity of funding sources and should be addressed as part of the Capital Markets Union strategy.

In sum, we believe that the goals of MiFID II transparency would be better served by providing incentives for reducing complexity and standardizing financial instruments. At the same time, there should remain ample room for tailor-made bilateral instruments. In any case, the current approach of mandatory transparency for market finance is perceived as putting the cart (transparency) before the horse (liquidity).

Key Recommendation 2:

The AFM is of the opinion that the MiFID II goals of transparent fixed income markets can best be realized by stimulating a standardization of issuance practices and by reducing complexities for eligible instruments and issuers. This requires a concerted effort between market participants, issuers and the regulatory community.

4. Taking the long view: towards a broader MiFID II review perspective

Within the context of the ESMA mandate to review parts of MiFID II and MiFIR, we see a number of opportunities to address some of our main concerns and observations. The first opportunity is the review of the non-equity transparency architecture assessing the waiver and deferral structure, data quality and the derivative trading obligation (DTO). The non-equity transparency consultation is followed by the consultation on Organised Trading Facilities covering broader (multilateral) market structure issues.

While we explicitly applaud the effort by ESMA to analyze and address non-equity transparency and market structure, we believe the current review mandate only enables ESMA and NCAs to focus on symptoms rather than causes. These causes can only be addressed by taking a broader perspective on some fundamental observations in relation to market structure and transparency. We do this through a critical assessment of the fixed income market structure and instruments characteristics by focusing on two themes: 1.) Level playing field and 2.) Reducing complexity and focus on meaningful transparency. We believe that addressing these themes is necessary for creating the right conditions for further instrument standardization and working towards meaningful transparency.

Theme 1: Level playing field

Based on our analysis, we find that improving the level playing field in the fixed income markets is one of the key recurring themes. In the AFM's view, a significant level playing field issue concerns the competition between closed broker dealer markets and open order competition on regulated platforms. Where MiFIDI already allowed for execution of financial instruments on regulated markets and MTFs, the nature of most fixed income transactions did not always fit into this mold. In order to further bring such trading models into the scope of transparency, MiFIDII introduced the organized trading facility (OTF) as a new type of trading venue.

At this stage, it is becoming clear that the boundary between a regulated multilateral venue and a technology/communication platform is thin. Since MiFID II has significantly raised regulatory burdens for operating a trading venue, this has incentivized firms to avoid these costs and operate close to or beyond regulatory delineations. Sometimes even unintentionally.

Furthermore, a complicating factor is that the trading venue licensing requirements are part of MiFID This is causing national transposition and interpretation issues on the definition of a multilateral system. The AFM believes this be addressed by transferring the licensing obligation that is currently in art 1.7. MiFID II, to the regulation (MiFIR). This would create more legal certainty about what constitutes a multilateral system and to what extent it should be subject to the full regulatory framework.

1) *To protect the integrity of the European capital markets and prevent regulatory arbitrage Article 1.7 of the Directive should be added to the Regulation.*

In addition, the AFM endorses more supervisory convergence at ESMA level. Effective enforcement can only be done at the European level, to guarantee that European investment firms cannot "benefit" from regulatory arbitrage. Furthermore, better alignment between securities markets and prudential regulators is needed as a pre-requisite to ensure that trading venue-like operations by commercial banks, as well as bank-operated systematic internalisers face similar degrees of supervision and regulatory scrutiny.

2) Endorse more supervisory convergence around enforcement of article 1.7. at ESMA level.

A third level playing field issue concerns the requirements of Article 17 for algorithmic trading and high frequency trading. With the introduction of MiFID II and the growth of electronic trading, SI platforms are becoming increasingly important for price formation and face similar risks of causing unorderly trading. To ensure orderly markets and protect the level playing field with multilateral trading venues, SIs should be included in the algo trading requirements.

3) *Adjust article 17 of MiFID II to include algorithmic OTC trading.*

Theme 2: Reduce complexity & focus on achieving meaningful transparency

The current waiver and deferral structure

A second theme that emerges from discussions with market participants, concerns the criticism that the scope of MiFID II transparency is too large. In the AFM's view, the current transparency waiver and deferral structure.

As described above, the lack of secondary market liquidity as a result of instrument and market participant characteristics already results in more than 75% of notional trading volume in fixed income instruments benefitting from a pre-trade transparency waiver.[5]

The same applies for deferrals, where actual real-time post-trade transparency for fixed income instruments remains extremely limited. National discretions are mostly used to push the deferral period to the maximum of four weeks.

As described above, we believe that simply addressing the waiver structure and changing thresholds is not sufficient. Rather, market fundamentals should be addressed to ensure meaningful transparency.

Transparency scope and data quality

Our overall observation is that the current scope of transparency in the fixed income markets is too wide and hampers the development of the European capital market. This especially applies to instruments that are mostly still traded on primary bilateral markets and within a trusted

[5] See ESMA MiFID II/ MiFIR review report on the transparency regime for non-equity instruments and the trading obligation for derivatives (2020).

relationship. Since much of these instruments are issued for very specific reasons and are subsequently kept on the shelve with buy- and hold investors or are being purchased by central banks, much of these instruments seek no secondary market liquidity or secondary trading opportunities. Such instruments would generally not contribute to meaningful instrument reference data, nor pre- and post-trade transparency.

This observation is echoed by market participants and data users.

Focus on improving liquid instrument transparency data

To improve the cost-benefit balance of the regime and to promote meaningful transparency, the AFM believes the transparency scope could be more focused on improving transparency of liquid fixed income instruments. It is becoming increasingly clear that the benefits of pre- and post-trade transparency in illiquid non-equity instruments do not weigh up to the large costs associated with providing the data at acceptable quality levels that makes them meaningful. Focus on liquid instruments would be a prerequisite to work towards meaningful instrument reference and transparency for market participants, investors and supervisors. Focus on liquid instruments would concentrate supervisory efforts to increase data quality and add emphasis to the visibility of meaningful liquidity.

We believe the most straightforward approach would be to permanently waive the pre-trade transparency requirements for illiquid instruments. Given the characteristics of the fixed income markets, types of participants and the bespoke nature of such instruments, we believe there is very little added value in pre-trade data that cannot be used for price discovery or for obtaining a consolidated market view. In order to further simplify the regime and increase the level the playing field between trading protocols, the AFM supports ESMA's suggestion to only retain the LIS waiver.

This focus on liquid instruments would also alleviate concerns that continuous supervisory scrutiny focused on the detailed workings of multilateral trading protocols (such as RFQ) may even discourage on venue trading in comparison to OTC/Voice trading. This in contrast to the AFMs belief that on-venue trading via e.g. RFQ protocols on multilateral platforms inherently provides increased transparency compared to voice trading.

We believe this simplified approach would provide an ex-ante reduction of the data burden and would rationalize requirements on issuers, dealers, trading venues and supervisors. The main condition for this approach is that it should be done in conjunction with increased supervisory efforts on improving data quality, combined with enforcement.

Post-trade transparency and CTP

In order to ensure a consolidated market view and increasing the level playing field with access to information, a concentrated effort is needed on improving post-trade data quality. Although the current post-trade transparency regime provides for a publication of all tickets after four weeks, the many deferral options (including national discretions) provide for a complex and disorderly picture jeopardizing data quality, consolidation as well as best execution analysis. The AFM would

be a strong proponent of further simplification and harmonization of the current MiFIR post-trade requirements into a single regime, including the removal of supplementary national deferral options.

Once data quality is improved on this basis, a logical next step is that market visibility could be further improved by the introduction of a post-trade consolidated tape (CTP) containing basic information such as price, size, trading venue, volume, timestamp of execution, yield and tenor. A CTP would create immediate visibility for market users and supervisors alike, allowing for transparency in key fields and a clear overview of transaction publications. For market participants, near real-time post-trade transparency supplemented by a CTP could help improve access to market data given the current levels of fragmentation. A better market overview would allow for easier identification of trading opportunities at a much earlier stages, as has been demonstrated in the US following the introduction of TRACE[6].

Reporting of illiquid instruments

In addition to reducing the transparency scope, the AFM also believes that to ease resources, reduce the data burden and realign efforts with secondary markets supervision, instruments that are illiquid for transparency purposes should no longer be required to provide a separate identifier.

Regulatory transaction reporting (to NCAs) of these illiquid instruments could continue to serve the existing class based size and liquidity calculations used by ESMA for the periodical reassessment of the liquidity status of the particular class. Abilities to detect trading on inside information, should also remain intact.

To implement these changes, both the transparency requirement as well as the regulatory reporting requirements would have to be amended. It would require the introduction of a comprehensive waiver for pre-trade transparency for illiquid instruments and the introduction of a class-of-instruments approach for regulatory transaction reporting in non-equity segments.

4) Remove illiquid non-equity instruments from the scope of pre-trade transparency.

5) Focus on improving (real-time) data quality for all liquid instruments.

6) Introduce a post-trade consolidated tape for all instruments

7) Remove the reference data requirement based on IBIA for illiquid instruments.

This same issue in relation to large amounts of low quality data, also often leads to the criticism that NCAs have not captured the economies of scale that are possible at the EU level. The AFM is a front runner on this and has been able to lower costs and achieve economies of scale through the cooperation with Nordic NCAs in the NTRS initiative. Given the rather uniform requirements of data handling and report querying, large costs savings could be achieved with data quality supervision and application development at EU level. This could be achieved by consolidating data collection at

[6] Adem Dugalic, Corporate Bond Market Post-Trade Transparency and Dealer Behavior (Stanford University), 12 December 2017.

ESMA level through a centralized depository. This would converge data standards, reduce redundancies, and capture economies of scale and lower supervisory costs across the EU.

8) Capture economies of scale in data driven supervision by centralizing it at EU level to lower costs and increase operational efficiency.

Specific findings for the OTC Derivative Markets

Derivative Trading Obligation (DTO) and ToTV

The DTO mandates that derivative segments subject to the clearing obligation (such as interest rate and credit derivatives) have to be traded on a regulated market (RM), MTF, OTF or equivalent third country venue. The DTO is based on whether an instrument is subject to the clearing obligation, if it can be traded on a trading venue and whether the instrument is sufficiently liquid. It is a key part of the post- financial crisis G20 commitments. During the drafting of the Level 2 legislation in 2016, there were severe doubts about the quality of the DTO liquidity calculations due to a lack of reliable data.

Therefore, a separate liquidity assessment was introduced that reduced the scope of the DTO to roughly the fifty most liquid individual contracts of 2016. These fifty contracts are embedded into the regulation and when liquidity shifts to other type of contracts it requires an amendment of Level II to adjust the DTO.

Current levels of data allow for a less cautious approach to the trading obligation for derivatives (DTO). Despite of the limited scope of the DTO[7], the trading of derivatives on regulated markets and MTFs has grown, even for the individual contracts that are not subject to the DTO. To reduce complexity and further stimulate transparent derivative markets, the DTO liquidity status could be aligned with that the assessment methodology used for transparency purposes. This would replace the current static approach to liquidity (based on 2016 data) with the existing class-of-instrument based periodic transparency calculations.

9) Expand the DTO by aligning the liquidity assessment for the DTO with that of transparency. This reduces complexity and strengthens centrally cleared and transparent derivatives market.

For transparency purposes, the concept of Traded on a Trading Venue (TOTV) for OTC derivatives was introduced in MiFIR to ensure that OTC transactions would still contribute to post-trade transparency. It entails that instruments that are traded OTC, but share the reference data characteristics of instruments that are admitted to trading on a trading venue would have to contribute to post-trade transparency. In the AFM's view, this approach currently narrows the scope of the instruments significantly and exempts a wide range of instruments traded OTC, especially those traded on SIs. The AFM would be supportive to broaden the instrument scope significantly, in line with the G20 commitment to further improve OTC derivative transparency and given the expansion of the SI presence following the introduction MiFID II. Broadening of the concept could be achieved by either abandoning the concept of ToTV altogether and make any OTC derivative subject to post-trade transparency, in line with the current approach in the United States.

[7] As of June 2020, the DTO applies to eight classes of OTC fixed to float single currency interest rate swaps denominated in EUR, USD, GBP on Libor and Euribor with main tenors (3M, 6M). The DTO applies also to two classes of index credit default swaps on Itraxx Europe Main and crossover indices with a maturity of 5Y.

An alternative approach would to focus on the specific role of SIs and increase the ToTV concept to transactions involving an SI as counterparty.

10) Expand the scope of ToTV for OTC instruments, especially those traded on systematic internalisers

In the context of the DTO, the clearing obligation of EMIR is most often credited with providing these derivative markets with a degree of standardization that makes lit exchange models more attractive. Because of the success of the clearing obligation, the AFM would also invite ESMA and other stakeholders to consider expanding its scope towards foreign exchange (FX swaps and forwards) and commodity derivatives that are cash settled. Since this constitutes EMIR this could be addressed through the ESMA CCP Policy Committee.

11) Expand the clearing obligation to FX and cash settled commodity markets.

4.1 Annex 1: overview proposed measures

Topic		Article	Text	Amendment
Standardisation	Level 1			*Introduce targeted instrument design standards that promote the liquidity of certain classes of financial instruments.*
Licensing Requirements	Level 1	MiFID II Article 1(7)	All multilateral systems in financial instruments shall operate either in accordance with the provisions of Title II concerning MTFs or OTFs or the provisions of Title III concerning regulated markets.	*Add the licensing requirement of the directive (article 1.7) to the regulation (MiFIR).*
OTC Algorithmic Trading	Level 1	MiFID II Article 17	An investment firm that engages in algorithmic trading shall	*Adjust article 17 of MiFID II to include algorithmic OTC trading.*

			have in place effective systems and risk controls.	
Pre-trade Transparency	Level 1			*Waive pre-trade transparency for illiquid non-equity instruments.*
Post-trade consolidated tape	Level 1			*Introduce a post-trade consolidated tape for liquid instruments.*
Reference data	Level 2 (RTS2)			*Remove the individual reference data requirements and/or ISINs for illiquid instrument (classes).*
Liquidity Assessments DTO	Level 2 (RTS2)			*Align the liquidity assessments for the DTO and transparency to reduce complexity and strengthen cleared, transparent trading models in derivatives market.*

Clearing obligation	Level 2 (EMIR)			*Expand the clearing obligation to FX and cash settled commodity markets.*
Data supervision centralization	Level 1			*Pool investments and the coordination of the development of data driven supervisory solutions at the ESMA level.*
ToTV	Level 1/2			*Expand the scope of ToTV for OTC instruments, especially those traded on systematic internalisers*

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