



A review of MiFID II and MiFIR

Recommendations on transparency and a consolidated tape

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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

In this paper, the AFM sets out its priorities for the upcoming Review of MiFID II and MiFIR on transparency and the implementation of a consolidated tape. The paper is organised around equity, bond, and derivative markets.

In line with its broader policy objectives, the key consideration for the AFM is that any amendment to the MiFIDII/MiFIR regime should be around achieving meaningful transparency while incentivising the execution of transactions on open multilateral trading venues where appropriate. Increasing meaningful transparency is 1) a cornerstone of achieving the goal of a CMU, 2) leads to better price formation and efficient allocation of capital, 3) enables the early identification of risks to financial stability, and 4) ensures better market integrity.

Our recommendations include:

- **[Bonds & Equity]** Creating a post-trade Consolidated Tape for equity and bonds is a priority. Data quality and transparency on cost of market data need to be improved, in which supervisory action and convergence are necessary.
- **[Bonds]** Incentivising transparent forms of multilateral trading in liquid instruments on trading venues. The current waiver and deferral regime needs to be simplified, and at the same time the liquid instrument scope as defined in RTS2 needs to be increased. Support a rapid completion of the transparency determination phase-in for bonds.
- **[Bonds]** Incentivising more trading to take place on venue by scrutinizing further OTC- and voice trading, rather than creating even more restrictive demands on trading protocols such as Request-for-Quote (RfQ) systems which instead would discourage trading on venue.
- **[Bonds]** the AFM believes the underlying issues in the EU's bond market cannot simply be addressed by just focusing on improving instrument transparency. The lack of transparency is the direct result of the current structure of the EU's fixed income market and warrants a more fundamental rethink in the context of the Capital Markets Union.
- **[Derivatives]** Reducing complexity and increasing flexibility as regards the scope of the Derivatives Trading Obligation (DTO), aiming to stimulate further transparent derivative markets, for example by aligning the DTO liquidity status with the assessment methodology used for "non-equity" transparency purposes.
- **[Derivatives]** Broadening of the concept of Traded-on-Trading-Venue (ToTV) by following the US in making any cleared OTC derivative subject to post-trade transparency unless such transactions are above a Large-in-Scale (LiS) threshold; or by increasing the ToTV concept to transactions involving a Systematic Internaliser (SI) as counterparty.
- **[Equity]** Stimulating transparency in equity markets by simplifying the Double Volume Cap (DVC) and restricting the execution of transactions under the Share Trading Obligation (STO) on Systematic Internalisers (SIs) to those above the Large-in-Scale (LiS) threshold.

Introduction

The European Commission (EC) has indicated it will propose a range of legislative changes to the current MiFID II and MiFIR framework. The proposed revisions are likely to focus on the pre- and post-trade transparency framework¹¹, as well as the establishment of a consolidated tape (CTP). As part of its overall vision on the merits of open and transparent multilateral markets combined with the changes to EU's market structure following the UK's departure of the EU, the AFM has published two in-depth analyses and a series of recommendations on the working of MiFID/MiFIR across different asset classes in 2020.²² Since the end of the Brexit transition period, the AFM's supervisory scope has expanded significantly resulting from the presence of a large number of trading platforms with major market shares across the EU's equity, derivative and bond markets.

In this discussion paper, the AFM aims to set out a number of specific recommendations focused on achieving meaningful transparency by improving the pre- and post-trade transparency framework for equities, derivatives and bonds, as well as our view on the establishment of a post-trade consolidated tape for equities and bonds.

In line with its broader policy objectives, the key consideration for the AFM is that any amendment to the regime should be around achieving meaningful transparency while incentivising the execution of transactions on open multilateral trading venues where appropriate. Increasing meaningful transparency is 1) a cornerstone of achieving the goal of a CMU, 2) leads to better price formation and efficient allocation of capital, 3) enables the early identification of risks to financial stability, and 4) ensures better market integrity.

Within the context of MiFID/MiFIR review, given the different characteristics of asset classes, the AFM is keen to ensure that an amended MiFID/MiFIR transparency framework better reflects the applicable market structure, trading protocols and participant types. At the same time, the overall goal of transparency should be about enabling market participants to identify trading opportunities, assess the quality of execution and ultimately contribute to adequate investor protection. Furthermore, rather than making a distinction between "equity and non-equity", the AFM proposes separate approaches for equity (including equity-like instruments), bonds and derivatives. Our recommendations are set out below.

¹ Pre- and post-trade transparency requirements are set by MiFIR. Pre-trade information includes current bid and offer prices and the depth of trading interests at those prices. The information has to be made available (by market operators and investment firms operating a trading venue) to the public on a continuous basis during normal trading hours. Market operators and investment firms operating a trading venue shall give access on reasonable commercial terms and a non-discriminatory basis. Post-trade information includes the price, volume and time of the executed transactions. Details of such transactions shall be made public as close to real time as is technically possible and free of charge after 15 minutes delay. There are several options for waivers of pre-trade information and for deferral of post-trade information.

² AFM MiFID II Review Equity, Commodity & Investor Protection <https://www.afm.nl/~profmedia/files/rapporten/2020/impact-mifid2.pdf?la=en> ; AFM MiFID II Review Fixed Income & Derivatives <https://www.afm.nl/~profmedia/files/publicaties/2020/mifid-review-non-equity-external.pdf?la=en>

General observations on the impact of MiFID/MiFIR on the equity, fixed income, and derivative markets

Although MiFID II has certainly brought improvements, we find in our analysis that the overall sentiment among market participants in the fixed income and derivative markets is that MiFID II has not yet delivered on all of its goals.

In the fixed income markets, feedback includes the observation that MiFID II transparency raised the costs of doing business while adding little meaningful transparency and leading to higher costs of execution. Despite all efforts, the fixed income markets are still considered to remain largely closed to non-bank participants. The withdrawal of liquidity providers from this market is blamed largely on changes in capital requirements that have made holding trade-inventories more expensive for market makers.

The same sentiment dominates the image of MiFID II in the OTC derivatives market, although the tone there is a little more positive. This is for a large part due to the EMIR clearing obligation (CO) and the MiFIR Derivative Trading Obligation (DTO) for credit and rates, which are 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 participants 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. Unbundling of research costs are also said to have had a positive effect on awareness on trade execution routing decisions.

Given the specific characteristics of these different markets segments, 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 electronification of fixed income trading protocols towards platforms, only a small fraction of the EU fixed income and OTC derivative 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%³ of the trading in bonds is shielded away from transparency by using waivers and deferrals, mainly as a result of lack of liquidity of the instrument, while derivative market transparency relies on complicated processes based on the ToTV concept.

The main reforms introduced by MiFID II for equity and equity-like instruments have mainly sought to increase on-venue trading by moving trading from the dark (i.e. not pre-trade transparent) to lit trading venues. While MiFIR can be credited for providing a more solid regulatory framework for pre- and post-trade transparency, the AFM has genuine concerns on the manner in which market participants are increasingly seeking to diverge from transparent central limit order book (CLOB) models through increased forms internalisation, as well as through alternative types of trading and execution venues.

For all instruments types, it is also becoming clear that the boundary between a regulated multilateral venue and a technology/communication platform is thin. As MiFID II has significantly

³ <https://www.esma.europa.eu/press-news/esma-news/mifid-ii-esma-makes-new-bond-liquidity-data-available-6>

raised regulatory burdens for operating a trading venue, this has incentivized firms to avoid these costs and to operate close to or beyond regulatory delineations. Sometimes even unintentionally.

A complicating factor in this matter is that the trading venue licensing requirements are part of MiFID II. This has led to national transposition and interpretation issues on the definition of a multilateral system. The AFM believes this could be addressed by transferring (unchanged) 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.

Lastly, the growth of systematic internalisers (SI) has been subject to much debate since the implementation of MiFID II and MiFIR. The AFM believes SIs have a strong and specific role to play across all asset classes as alternative liquidity pools, essentially complementing the role of multilateral types of trading venues while putting their own capital at risk. In the AFM's view, the added value of SIs is twofold. SIs can (indirectly) act as important dealers and liquidity providers on multilateral venues by creating efficiencies in the systems and for end-users. However, the real added value and actual role of an SI is where it can offer tailored solutions in certain sizes to clients in (illiquid) instruments that are not contributing to price formation and/or protect its clients from undue exposures. In all other circumstances, a level playing field between SIs and multilateral trading venues is key.

Bonds

The European secondary market for fixed income instruments plays a more marginal role compared to the secondary market in equity instruments. Contrary to equity instruments, most debt funding by corporates and governments is spread over a multitude of (illiquid) instruments with different characteristics such as size, tenor, currency and yield. The EU debt markets are characterized by a strong primary market model with direct relationship-based interaction between issuers, dealers, agents and investors. Given the high demand for fixed income instruments by buy-and-hold investors and central bank bond purchasing programs, the secondary market (particularly for corporate bonds) is largely limited to newly issued instruments⁴ or the secondary market is used to execute pre-arranged bilateral OTC transactions. It does play a key role as price reference for both issuers and investors.

With a few exceptions, this is an institutional market between sell-side dealers and buy-side clients characterized by different trading protocols and market segmentation compared to the equity markets. The dealer-to-client (D2C) market consists of 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 and increasingly multilateral model for both price discovery and execution, mostly through a request for quote (RfQ) setup.⁵ The dealer-to-dealer (D2D) segment largely remains OTC and is bilateral and/or operating through interdealer broker platforms such as OTFs. With the exception of the Italian market, most instruments are not suitable nor designed for retail participation.

In such markets, the AFM believes that the current transparency framework leaves much room for improvement and further steps are needed to work towards achieving meaningful transparency. First, given the characteristics and illiquid nature of this market segment, many instruments have not become subject to transparency requirements given the large number of waivers and deferrals available to either prevent or delay publication of data to protect dealers from undue exposure. While MiFIR has rightly opted to focus mandatory transparency requirements on liquid instruments, we suggest, as a firm believer in the merits of open and transparent markets, that an amended MiFIR transparency framework should further focus on incentivizing transparent forms multilateral trading in liquid instruments on trading venues.

At the same time, in our supervisory experience, we note that the strong emphasis on liquid market segments has placed disproportionate supervisory scrutiny on unravelling the detailed workings of multilateral trading protocols (such as RfQ) as part of waiver assessments and venue supervision. For example, the interpretation of what constitutes an Actionable Indication of Interest (AIOI) has become rather legalistic and restrictive, allowing no flexibility around concepts which are common market practice such as indicative quotes. All the while, the even less transparent OTC/Voice trading space remained a full-fledged and thinly-regulated alternative for illiquid instruments. This is in contrast to the AFM's position that on-venue trading via e.g. RfQ

⁴ Such instruments are referred to as on-the-run and are mostly only liquid for a limited period of time (i.e. until the issuer issues a new instrument or has credit event).

⁵ A relatively recent model is the multilateral all-to-all or anonymized trading protocol 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.

protocols on multilateral platforms inherently provides increased transparency compared to voice trading. Continued regulatory scrutiny on the scope of the RfQ protocol and transparency requirements of indicative quotes will put a brake on the desired move of secondary fixed income markets from OTC/Voice to multilateral systems.

The AFM believes that this all warrants a rethink of the pre- and post-trade transparency framework to ensure transparency adds value in terms of contributing to identifying trading opportunities and ensuring best execution for investors. In our view, this entails a simplification of the current regime by restricting pre- and post-trade transparency requirements to liquid instruments, with transparency exceptions limited to transaction size only. This means that the waiver for illiquid instruments will be made permanent and all other waivers will be terminated, except those for large- in-scale (LiS) transactions to prevent undue exposures. While 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 of information as well as best execution analysis. The AFM would strongly support further simplification and harmonization of the current MiFIR post-trade requirements into a single regime, limited to a time-limited deferral for LiS transactions only. Furthermore, the scope of instruments subject to transparency should be increased by rapidly completing the phase-in for bond transparency determination as defined in Regulation (EU) 2017/583.⁶

In order to ensure better accessible post-trade bond data, a comprehensive market view for price reference information and the ability to assess best execution⁷, the AFM remains a strong proponent of establishing a post-trade CTP for bonds for liquid instruments.⁸ The AFM believes a bond CTP should be a market driven initiative in a competitive setting based on clear industry standards on technology, costs/revenues and governance. The level of changes required to the current regulatory framework would depend on the scope, speed (real-time/delayed) and mandatory/non mandatory character of such a CTP. In general, we note a strong role for the regulatory community to ensure the right conditions are in place for a successful establishment of a CTP. This role should focus on ensuring that the necessary data should be readily available for CTP providers through better enforcement of existing rules for data providers (i.e. trading venues and APAs).

Other longer term considerations for the EU bond markets

All in all, the AFM believes the underlying issues in the EU's bond market cannot simply be addressed by focusing merely on improving instrument transparency. The lack of transparency is the direct result of the current structure of the EU's fixed income market and warrants a more fundamental rethink, especially in comparison with the market structure in the United States. Such considerations include the strong relationship component and lack of innovation by the main participants, the manner in which instruments are issued and distributed, the impact of capital requirements on dealers, barriers to entry for non-bank participants, concentration risks and

⁶ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0583&from=EN>

⁷ Given the structure and applicable trading protocols in the bond market, a CTP would have less added value in terms of i.e. price discovery.

⁸ The highly transparent US model provides a clear example of how a CTP leads to significant improvements in terms of transparency, non- dealer participation, reduction of spreads and more liquid instruments.

existing post-trade barriers. The AFM would encourage the European Commission to seek further views on i.e. the harmonization of issuance practices, post-trade efficiencies and alternative transparency determinations models. One could also investigate whether it is worthwhile introducing a clearing mandate for liquid instruments to better mutualise risks, encouraging forms of multilateral anonymous trading, as well as enabling broader participation by reducing dependencies on dealers and their balance sheets.⁹ Lastly, a more ambitious approach worth studying in further detail is to facilitate a bond CTP by introducing a trading obligation for (sufficiently liquid) bonds, which would allow for more trade information to become available.

⁹ Note a recent study by the Brookings Institution on this topic:

<https://www.brookings.edu/research/enhancing-liquidity-of-the-u-s-treasury-market-under-stress/>

OTC Derivatives

The majority of the MiFIDII/MiFIR requirements around transparency and mandatory on-venue trading requirements for OTC derivatives can be directly attributed to the 2009 G20 commitments on derivative market reform. The main reforms included pre- and post-trade transparency for instruments that are traded on-venue or can be traded on venue, combined with a trading obligation for the most liquid instruments (DTO).¹⁰ A similar approach was taken in the United States with near-real time trade reporting with limited deferrals based on size, combined with a broader mandate to execute Made Available to Trade instruments (MAT – the US DTO equivalent) on a swap execution facility (SEF).

The introduction of the DTO in the EU and MAT in the US have been widely credited for encouraging the rapid growth of on-venue trading of OTC derivatives. Despite of the limited scope of the DTO¹⁰, the trading of derivatives on regulated markets, OTFs and MTFs has grown strongly, even for individual contracts that are not subject to the DTO. To reduce complexity, to increase flexibility on scope, and to stimulate further transparent derivative markets, the AFM believes the DTO liquidity status could be aligned with the assessment methodology used for “non-equity” 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. More flexibility on the DTO scope would also enable a smooth transition to contracts based on new risk-free rates following the termination of i.e. LIBOR and EURIBOR.

For transparency purposes, the concept of Traded on a Trading Venue (TOTV) for OTC derivatives was introduced in MiFIR to ensure 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 cleared OTC derivative subject to post-trade transparency unless such transactions are above a LiS threshold, in line with the current approach in the United States. An alternative approach would be to focus on the specific role of SIs and increase the ToTV concept to transactions involving an SI as counterparty. All in all, in line with our recommendations for the fixed income market described above, the AFM would favour a similar approach for achieving meaningful transparency for derivatives by restricting the use of pre-trade waivers to LiS transactions and harmonizing the deferral regime restricted to a single deferral for LiS transactions.

¹⁰ 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.

Equity and equity-like instruments

The MiFID II / MiFIR requirements have tried to increase transparency in trading equity and equity-like instruments (e.g. ETFs and depository receipts), thereby contributing to the availability of trading information, an efficient price formation process and, ultimately, supporting the accurate valuation of products. In order to achieve these aims, MiFID II has sought to increase on-venue trading by moving trading from the dark (i.e. not pre-trade transparent) to lit trading venues. This should result in more liquid and transparent equity markets. At the same time, the AFM has genuine concerns on the manner in which market participants are increasingly seeking to diverge from the transparent central-limit- order-book model through increased forms of internalisation by banks and brokers, as well as the rise of alternative trading venues types.¹¹ We also note an increasing internalisation of retail flows resulting from zero commission brokerage models and forms of payment for order flow on certain venue types and in certain jurisdictions. Increased internalisation and circumvention of MiFIR transparency requirements is to the detriment of the availability of reference price information, ultimately affecting (end) investors and the integrity of the CMU.

While these are more fundamental concerns, the AFM supports a number of quick wins as set out in the *ESMA MiFID II/MiFIR Review Report on the transparency regime for equity and equity-like instruments*. First, the Double Volume Cap (DVC). The DVC limits trading of liquid instruments under the negotiated transaction waiver and under the reference price waiver. In these cases, trading under such waivers would unduly harm the price formation process. However, the DVC is currently unnecessarily complex with different thresholds: AFM support simplification towards a single threshold (probably in somewhere between the two existing ones).

As regards the Share Trading Obligation (STO), AFM strongly supports the concept that liquid EU shares should be traded on an EU trading venue, thereby moving more trading into the lit. The Systematic Internaliser (SI) is a possible execution place for the STO, and it is widely acknowledged that SIs play an important role in providing liquidity for e.g. larger trades. AFM agrees with the *ESMA MiFID II/MiFIR Review Report on the transparency regime for equity and equity-like instruments* in allowing SIs as an eligible execution venue for the STO. However, one must also consider whether there are level playing issues between transparent multilateral trading venues and SIs. Therefore, one should consider whether smaller trades should also be allowed to be executed on SIs in the first place: there only seems to be a case for SIs to serve as a possible execution place for trades subject to the STO above the Large- in-Scale (LiS) threshold.

Our discussion with stakeholders on data consolidation and the price of market date revealed that a large part of market participants view post-trade Consolidated Tape Provider (CTP) as an essential part of the CMU, as well as for improving the availability of common reference price information resulting from a highly fragmented market. There are preconditions for the establishment of an equity CTP: is the quality of data sufficient to make it meaningful; is it practicable as an IT project to make it real- time; and is there still a need by the time this large-scale IT project is finished? A CTP has the potential to improve transparency significantly by aggregating information from

¹¹ An example of such an alternative venue could be a venue which takes its reference prices from Regulated Markets, thereby claiming best execution combined with incentives for brokers to direct flow their way

increasingly fragmented markets across trading venues. Whilst AFM is supportive of establishing a real-time CTP, we also note some practical constraints, which should temper expectations. These include, amongst others, data quality, amount of data sources, achievability of real-time, and time-to-completion.

In line with recent experience of other NCAs in ESMA, it is our view that the data quality at APAs (Approved Publication Arrangements) needs to be improved, either on their own initiative or by way of regulatory enforcement action. What constitutes a reasonable cost of market data is fiercely contested by venues (sellers) and market participants (buyers). AFM shares ESMA's view that the cost of market data is not sufficiently transparent to buyers, and supports steps to improve this. Both improvement in data quality and transparency in costs may, however, not require legislative changes (with the associated delay). Equally important is a pan-European enforcement effort by relevant NCAs and ESMA to improve the situation based on the current rules, if anything aided by further ESMA guidelines and other supervisory convergence tools if required.

Annex 1: overview proposed measures

Topic		Article	Text	Amendment
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.	<i>Transfer the licensing requirement of the directive (article 1.7) to the regulation (MiFIR).</i>
Pre-trade Transparency	Level 1 / Level 2			<i>Waive pre-trade transparency for illiquid non-equity instruments. Waivers for liquid instruments limited to LiS only</i>

Post-Trade Transparency	Level 1 / Level 2			<i>Simplification and harmonization of the current MiFIR post-trade requirements into a single regime, limited to a short deferral for LiS transactions only.</i>
Post-trade consolidated tape	Level 1			<i>Introduce a post-trade consolidated tape for equity instruments and liquid bonds</i>

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