EU capital markets at a crossroads: Getting the MiFID II/MiFIR review right to unlock Europe's growth potential

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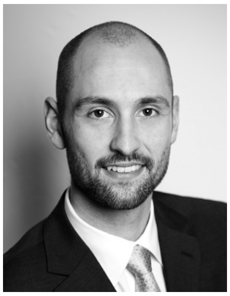

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Abstract

This paper explores the aims and scope of the MiFID II/MiFIR Review and its significance in unlocking Europe's growth potential amid current socioeconomic challenges. The EU's capital markets currently underperform globally, necessitating urgent structural reforms to enhance competitiveness and participation. The Markets in Financial Instruments Directive II (MiFID II)/ Markets in Financial Instruments Regulation (MiFIR) regime, designed to foster fair competition and investor confidence, has fallen short due to market fragmentation and regulatory inconsistencies. Addressing these issues requires transparent, resilient and integrated capital markets that prioritise liquidity, price formation and investor protection. Fragmentation in the EU equity market is a pressing concern, with off-book volumes increasing and exchanges experiencing a decline in trading flow. Enhancing transparency requirements, minimum order sizes and the dark trading cap, while simplifying waivers and deferrals, can help address these challenges. Implementing a consolidated tape (CT) to increase transparency in off-exchange trading is also crucial, with a phased-in approach recommended for reliable and high-quality data. Placing societal interests at the heart of these reforms is vital for achieving the EU's strategic autonomy and ensuring long-term economic growth. The MiFID II/MiFIR Review presents an opportunity to promote transparency, efficiency and investor protection, garnering citizen support and contributing to critical societal challenges. Readers can expect to gain knowledge of the current state of EU capital markets, the shortcomings of the MiFID II/MiFIR regime and the necessary reforms to unlock Europe's growth potential. They will understand the challenges posed by market fragmentation, the importance of transparency and liquidity and the role of a CT in enhancing the investment climate.

Keywords: equity trading, exchanges, financial market infrastructure

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INTRODUCTION

Europe finds itself in one of the most challenging environments for decades. Geopolitical realities are shifting, and we have entered a new era of global and European history. The COVID-19 aftermath as well as the war in Ukraine have taught us some painful lessons of our vulnerabilities and dependencies and add to the monumental financing challenges, notably around the sustainable and digital transformations. Coping with these realities short-term and adapting our way of living mid- to long-term are nothing less than genuine stress tests for our political systems, societies and economies alike.

The European Union (EU) is standing at a crossroads as the overall outlook has darkened dramatically if we pair the new geopolitical realities with weak economic growth, high inflation and skyrocketing prices, new constraints around monetary policy and public finances, unprecedented levels of debt and an increasingly constrained banking system.

The EU's response to the new geopolitical realities, however, has also shown a restrengthened unity and a clear commitment to restore Europe's autonomy and resilience in areas of key strategic relevance. In this context it is of critical importance to understand the crucial role of capital markets, as also structurally emphasised at the highest political level.

Capital markets are at the very heart of a successful transformation of the EU and will be key for a sustainable recovery from recent crises, financing transitional challenges and ensuring long-term economic growth.

EU CAPITAL MARKETS IN DECLINE: KEY PROXIES

Yet, despite many years of policy-making efforts to boost EU capital markets, a quick look at key proxies underlines that the EU's markets continue to underperform at global level and fall further behind (see Figure 1). This reinforces the urgent need to structurally boost EU capital markets, especially as the size and performance of the EU's capital markets do not adequately reflect the size and role of the EU economy:

- *Initial public offerings (IPOs)*: In 2021, around 2,700 IPOs took place globally, with over 70 per cent going live in the US and Asia, but only around 12% for the EU. On top, we observe that key European players are moving abroad;[1]
- *Market capitalisation*: In terms of market capitalisation, listed companies in the US come in at about 190 per cent of gross domestic product (GDP), whereas the comparative EU figure is only around 50 per cent;[2]
- *Citizens' participation*: Moreover, EU citizens are disproportionately underrepresented in our markets. Let us look at the German example: 40 per cent of the Deutscher Aktien Index (DAX) is owned by US investors, 20 per cent by UK investors, only 12 per cent by German investors;[3]
- *Strong outflow from European capital markets*: Especially during 2022, we continued to observe a strong capital outflow from EU capital markets towards the US and Asia — a critical signalling by global investors as regards our attractiveness. Net sales of German shares by foreign investors jumped to EUR €19.5bn (January–August 2022), EU equity funds faced the highest outflows since 2016 (US$31.2bn 2022 year to date), while US equity funds saw a massive inflow (US$ 72.69bn).[4]

Consequently, we urgently need to step up the game and unlock the unleashed growth potential of EU capital markets in a structural manner. If we truly want to deliver on the EU's objectives around an open strategic autonomy and global competitiveness, we

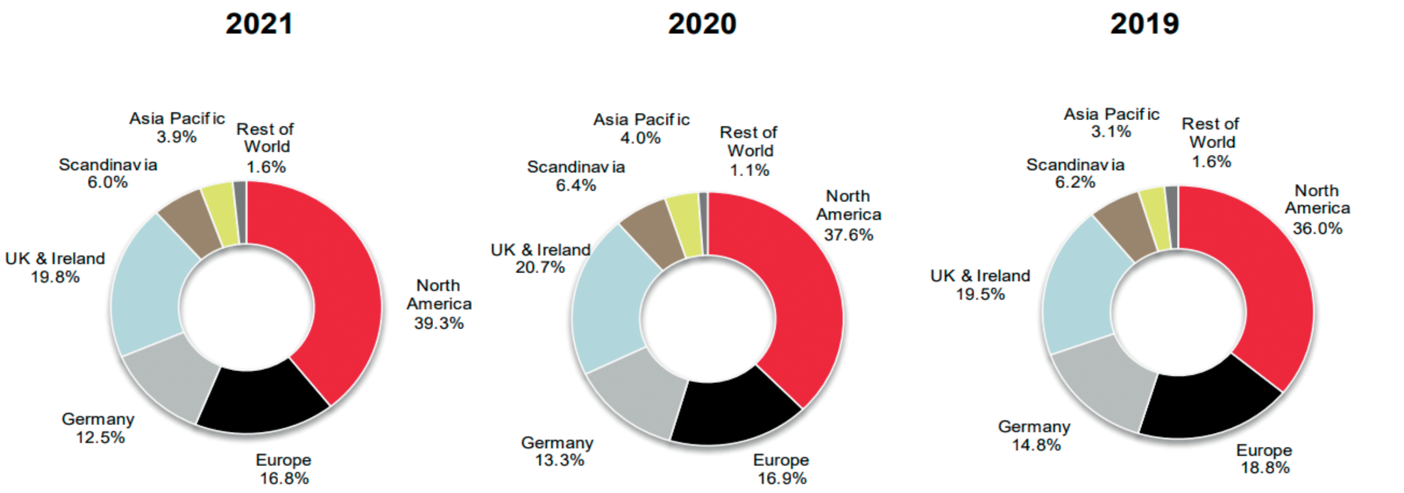

Figure 1 Shareholder structure by region[5]

cannot miss the opportunity to make our capital markets fit for purpose.

Strong, resilient and globally competitive EU financial market infrastructures (FMIs) are key in this regard, and I welcome Commissioner McGuinness' intention to strengthen EU FMIs.[6]

EU exchanges and central counterparties (CCPs) have not only proven to responsibly live up to regulators' expectation as the key anchor of financial stability in times of market stress and uncertainty — notably observed around the flight-to-quality concept. They also act as the backbone of the EU's capital markets and are a key vehicle to boosting growth while ensuring sound risk management and financial stability. Therefore, it will remain critical to translate the political objective of making EU FMIs stronger into concrete regulatory realities.

Major reforms of the regulatory frameworks shaping our primary and secondary markets are currently under way, with policy makers reviewing the MiFID II/MiFIR regime and the European Commission (EC) having tabled its proposal for an EU Listing Act. Both frameworks need to be driven with great ambition and clear guiding principles to foster transparent, efficient and competitive markets, serving our societal interests.

MIFID II/MIFIR: THE HEART OF EU FINANCIAL MARKETS' REGULATIONS IS OUT OF SYNC

The need for structural reforms around the Markets in Financial Instruments Directive II (MiFID II)/ Markets in Financial Instruments Regulation (MiFIR), the EU's heart of securities legislation, becomes particularly obvious when analysing empirical realities and benchmarking those against the original political objectives. When introduced in 2018, MiFID II/MiFIR sought to foster fair competition, strengthen price formation, support issuers raising capital and provide confidence for investors by increasing overall transparency.

After half a decade of experience with the new framework, however, it appears that the political objectives have not really been achieved. In particular, the high degree of fragmentation of our capital markets, notably in combination with a lack of transparency by alternative execution venues, is illustrative of an artificial hyper-competition that creates significant drawbacks for liquidity and broader market quality, posing a continuous threat to our markets' functioning and global competitiveness.

And while the concept of 'fragmentation' has received a lot of attention in recent years, this does not seem to hold true when it comes to discussing the EU's trading landscape. As per the official European Securities and Markets Authority (ESMA) statistics, the EU trading landscape sees about 500 trading and execution venues across all asset classes, with the degree of fragmentation being particularly pronounced on the equity side.[7] This compares to slightly more than 100 venues in the US, even though the US market is multiple times bigger.

As such, it appears that those jurisdictions that are home to the strongest capital markets globally do acknowledge the benefits of limiting fragmentation as a necessary precondition for deep pools of liquidity. Their philosophy focuses on global competition and ensuring champions. The EU, by contrast, seems to focus more on intra-EU competition, which comes at the expense of strong global players and integrated market structures.

Competition is clearly welcome as far as it brings more efficiency, better prices, more innovation and a general strive for excellence. In strong contrast, however, an artificial hyper-fragmentation driven by regulation comes at the expense of an efficient capital allocation across our economies, raises financing costs for issuers and generally widens bid-ask spreads — opening arbitrage and cream skimming opportunities, reducing overarching integrity and investor protection.

What appears particularly concerning is that the high degree of fragmentation in the EU's equity trading landscape is specifically driven by an unlevel playing field and different regulatory requirements between lit venues and the dark sphere (see Figure 2). With more than 188 systemic

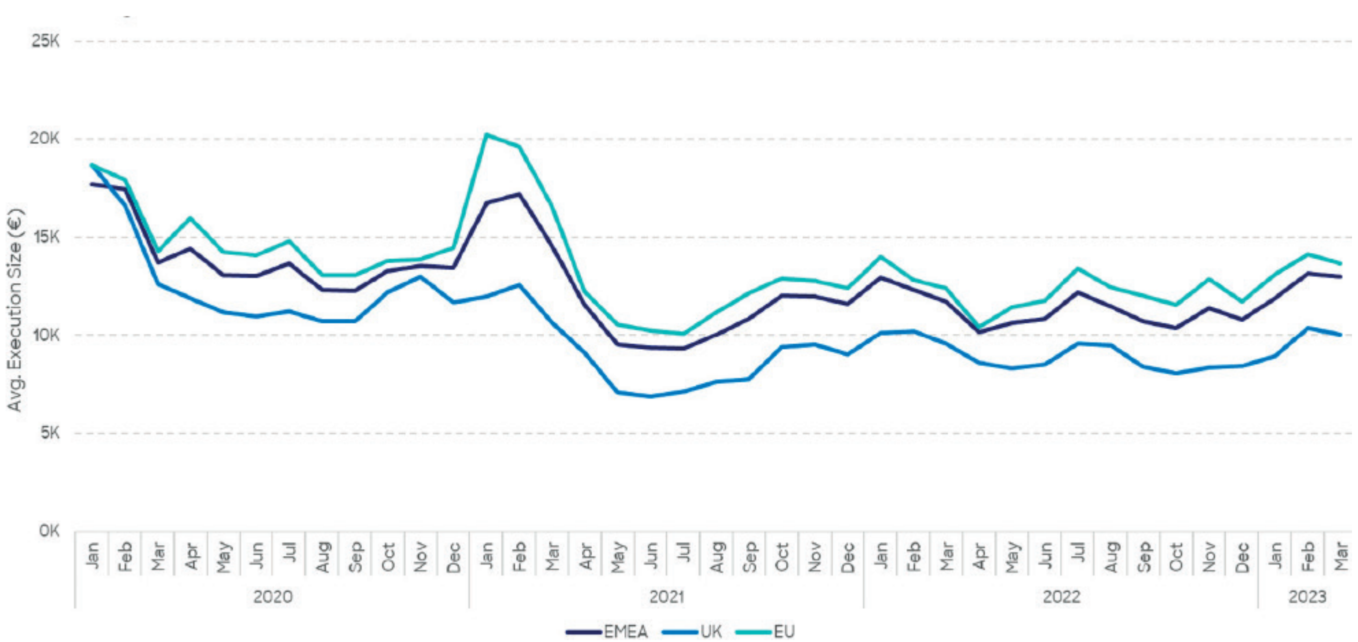

Figure 2 Dark execution size[11]

internalisers (SIs)[8] having been created since January 2018, it appears critical to remind ourselves that SIs were introduced as regulatory vehicles intended for large institutional transactions that deserve special treatment to avoid negative market impact.[9] Empirical realities show, however, that the average transaction size across SIs is far away from any large in scale (LIS) threshold while practically no contribution is being made to transparency.[10]

Concerns about the shape and development of equity markets are not only an EU phenomenon. When presenting his proposal to reinstate transparency and fair competition, SEC Chair Gary Gensler depicted the US market as 'not as fair and competitive as possible for individual investors', meaning in particular retail investors.[12] This is in part because there is no genuine level playing field across different parts of the market: wholesalers, dark pools and lit exchanges. And because the markets have become increasingly opaque, especially for individual investors.

One could hardly think of a more apt description of the situation in the EU, so the lessons learnt in the US equity market structure may be particularly important to understand when it comes to the planned EU reforms. While EU policy makers clearly recognised, however, that existing regulatory regimes need to be tweaked to boost EU capital markets' competitiveness on a global scale, the current considerations in the context of the MiFID II/MiFIR Review unfortunately run the risk of missing the window of opportunity.

We need to leverage on our strengths and create transparent, resilient and truly integrated EU capital markets, building on lit trading and efficient price formation. These fundamentals are of essential importance for the EU capital markets and should not be jeopardised in a race to the bottom in terms of transparency, investor protection and market integrity.

EU EQUITY MARKET STRUCTURE: HOW TO OVERCOME FRAGMENTATION WHILE BOOSTING TRANSPARENCY

Notably on the equity front, it is imperative to close loopholes and holistically address structural flaws, if we truly want to overcome the current level of fragmentation and restore a level playing field. Latest empirical realities clearly demonstrate that there is strong and dynamic push away from transparent exchange order books towards bilateral forms of execution.[13]

While equity markets' total volumes reached new record levels in 2022, there is a tremendous increase in off-book volumes at the expense of on-book transactions: market shares of lit continuous order books and auctions decreased from 63.3 per cent to 60.4 per cent compared to 2021 while off-book volumes surged from 36.8 per cent to 39.7 per cent.[14] Strikingly, negotiated trades have become the second largest liquidity pool in 2022, taking nearly 3.5 per cent market share away from the order book and reaching 20.8 per cent overall.[15] And as such, EU exchanges have lost about 50 per cent of their trading flow compared to the pre-MiFID II/MiFIR world (see Figure 3).

Paired with a persistent share of transactions conducted via SIs, this development points to a stable and even growing proportion of EU equity trading taking place in the non-lit world — away from transparent price formation on exchanges and absent a true multilateral interaction between buyers and sellers. Against this background, increasing transparency requirements for SIs, raising minimum order sizes, preserving and expanding the dark trading cap and simplifying the waiver and deferral regimes are important steps into the right direction.

The minimum order size for the reference price transparency exception and the minimum quoting obligation for SIs should be aligned and elevated in order to promote liquidity on transparent execution venues.

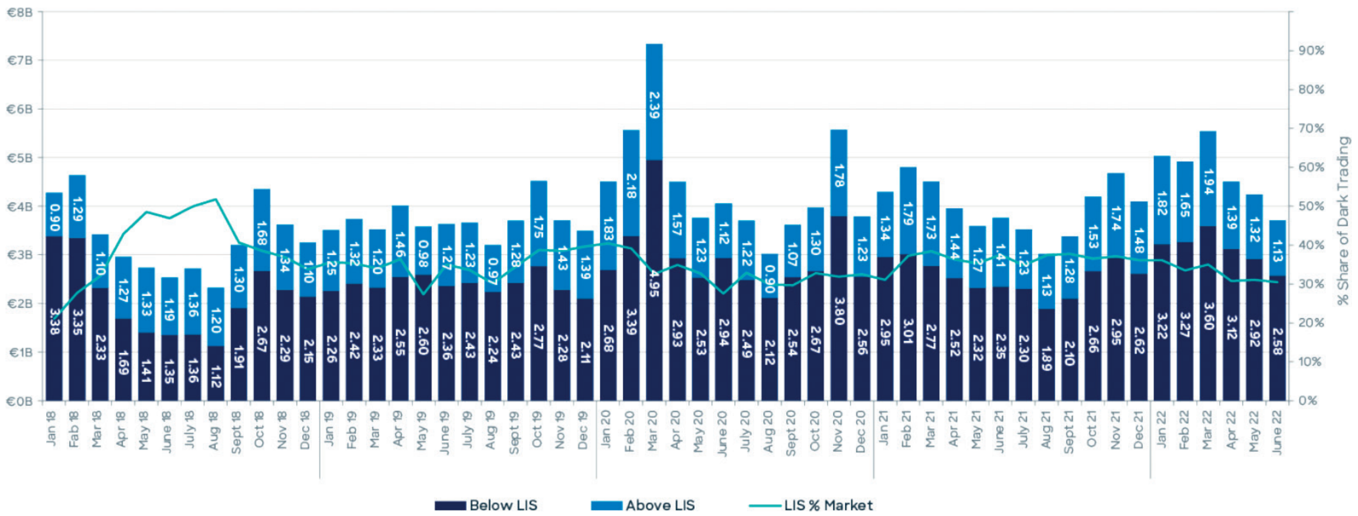

Figure 3 LIS as a percentage of overall dark market[16]

While not questioning the merit of SIs forming part of the EU financial market's landscape, the most effective way to address the shortcomings of the SI regime would be to ensure that SIs are only used for their original purpose, ie executing large institutional orders. It is economically sound that large trades benefit from transparency waivers and the discretional SI regime, but the regime should not be used for smaller trades.

Copying the UK's approach and allowing SIs to decide whether to opt-in may ultimately, however, be counterproductive where such an approach leads to inconsistencies with the share trading obligation. Rather, proper monitoring of SI activities and enhanced enforcement of existing rules are critical. This is particularly true when it comes to data quality, where the lack of enforcement and accuracy from the non-lit execution venues continues to constitute a severe issue.

This holds even more true should recent suggestions materialise around the deletion of the quantitative criteria for determining SIs, the easing of the minimum order size for the transparency requirements as well as the elimination of the restrictions for mid-point trading. Abolishing existing protection measures of the price formation process, price referencing execution strategies for small order sizes will continue to be possible without restrictions. This increases the discrepancy in competitive conditions and transparency standards between exchanges and bilateral, dark and semi-dark forms of execution.

Therefore, the EU should remain ambitious in the final sprint on the MiFIR Review — boosting transparency, fairness and integrity of our markets. And we should avoid allowing for new loopholes. If not adequately integrated into MiFIR's transparency regime, certain dark venues, such as frequent batch auctions (FBAs), will remain outside the transparency perimeter and may see tremendous growth, mirroring the growth in SIs and fragmentation when MiFID II kicked in. We should not repeat history and not continue to allow a strategic manoeuvring of big market participations between execution venues with different shades of opacity. Otherwise, we risk facing another surge of new venues in the dark, ultimately further weakening EU equity markets.

This reasoning holds equally true when it comes to the famous dark trading cap. After the double volume cap (DVC) provided, practically speaking, no added value and simply did not function as intended, it appears an interesting reflection by certain policymakers to propose a full deletion of the dark trading cap. Instead, we should ensure a meaningful reform of the dark trading cap, as it is crucial that especially price referencing transactions are under control and dark trading is effectively addressed.

Ideas about suspending and abolishing the dark trading cap may actually allow for dark volumes to grow without restriction. Therefore, we should pursue the proposed single volume cap (SVC) as a valuable tool to foster lit and transparent markets. The SVC should, however, be simplified and construed in a more comprehensive manner, capturing all dark and quasi-dark venues, including SIs und FBAs. In addition, a mandate should be given to ESMA to determine an appropriate threshold based on a comprehensive market analysis, rather than artificially limiting the room for manoeuvre via an inflexible threshold set at level 1.

CONSOLIDATED TAPE: SWITCH ON THE LIGHT FOR INVESTORS

Increasing and enforcing transparency requirements is also the necessary precondition for any meaningful, effective and efficient CT. Once data quality is ensured, a CT will have the most positive impact for those asset classes that are currently lacking transparency as being mostly traded off-exchange and in the dark.

To ensure a CT will stream correct and complete data, the first step for introducing the CTs should therefore be to guarantee reliable and high-quality data by all contributors. Unfortunately, however, the lack of data quality in the off-exchange segments does still not allow for proper consolidation at this stage — a clear market failure that requires regulators' intervention. If that were an easy task, a viable CT would have likely already emerged when the idea was first introduced by MiFID II/MiFIR.

Clearly, a well-designed CT can contribute to the Capital Markets Union (CMU) objectives, allowing investors a better overview of the liquidity in highly fragmented markets, thereby boosting the investment climate. But if the EU wants to have well-functioning and globally competitive markets in these challenging times, we should ensure an efficient and effective design of the CT.

Importantly, the project should be fast to implement to guarantee a strong contribution to the current macro-economic realities. If the overarching approach is designed in an overly complex manner, we may run the risk of not being able to deliver in this EU legislative period. Against this background, a sequencing and phased-in approach of the different tapes should be ensured, depending on the empirical realities in terms of transparency and data quality, thereby starting with bonds, followed by OTC derivatives, exchange-traded fund (ETFs) and equities.

For the equity CT to deliver concrete value, we should not only ensure sufficient data quality as a starting point, but also guarantee that the CT covers the full EU market. The latest ideas around carve-outs for smaller markets will divide the EU's equity markets further, based on the artificial degree of regulatory fragmentation injected via MiFID II/MiFIR. Such a split appears not only highly discriminatory, but also leads the whole CT project *ad absurdum* by consequently not providing a full overview of the EU markets. And it would yet again emphasise that the EU is not able to deliver on a true CMU but rather works on the back of political compromises that may mean one step forward and two steps back.

It is equally critical to avoid the establishment of an equity CT which leads to a two-tier market that would allow better-informed investors to front-run the market at the expense of lesser informed investors — notably retail investors. A pre-trade data equity CT would, however, precisely inject these unintended consequences. Due to latency, such an equity CT set-up would permanently mislead investors using the CT as real prices will have jumped multiple times in the meantime — knowledge that will only be accessible for better-informed investors with lower latency feeds.

In addition, it might make sense to practically assess the theoretical policy considerations from a retail perspective, ie any pre-trade data equity CT would result in retail investors facing a constantly flickering screen where it is clear that non-human trading will see artificial advantages that run counter to the overarching objectives around investor protection, integrity and, of course, the broader CMU endeavour. And should SIs, for example, be asked to become pre-trade transparent up to a certain threshold and feed into the CT, retail investors would face a reality where they may see better prices but cannot access them due to non-connectivity and discriminatory rule books in alternative execution venues.

Considering the urgent need to deliver a CT in a swift manner while paying regard to the need to ensure a balanced set-up that does not come with unintended consequences for the quality and integrity of EU equity markets, a post-trade equity CT appears to be a viable staring point that might be worth pursuing as a first step. Once a successful implementation of such a set-up has proven its value for EU equity markets, future reviews could determine if an expansion of the design is required, while avoiding an overly complex and lengthy implementation.

PLACING SOCIETAL INTERESTS AT THE HEART OF A CLEAR VISION TO BOOST THE STRATEGIC AUTONOMY

At this critical juncture of European history, it should be our joint vision to structurally strengthen EU capital markets in the interest of our society — not in the singular interests of only a few market participants. Too much is at stake in the bigger picture for the EU to lose additional time on strengthening its markets.

The EU should therefore use the MiFID II/MiFIR Review wisely, not compromising on the objectives of increasing transparency and catering for the EU ambitions around an open strategic autonomy. Boosting transparency, efficiency and overarching investor protection may also help to ensure a stronger endorsement of the capital markets agenda by EU citizens.

Only if we manage to collectively assume our responsibility in ensuring that capital markets are finding themselves in a consistent framework that maximises their growth contribution capacity without compromising financial stability as the cornerstone of sustainable economic growth, will we be able to lay the foundation for an appropriate contribution to critical societal challenges in the sustainable interest of future generations.

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