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SAFE Finance Blog

"MiFID II will Change the European Financial Markets Fundamentally"

01/08/2018

Peter Gomber about the reorganization of the market structure and more transparency



On 3 January 2018, with a one-year delay, the time had come: EU market participants must apply the revised Markets in Financial Instruments Directive (MiFID II) since this day. The implementation period had been extended by one year due to the high expenditure of time for the establishment of the necessary

complex technical infrastructure. The newly created accompanying regulation MiFIR shall likewise be applied since 3 January 2018.

The new rules of MiFID II and MiFIR will fundamentally change and reorganize the European financial

The new rules of MiFID II and MiFIR will fundamentally change and reorganize the European financial markets. The greatest impact on market structures and competition is to be expected through:

- the implementation of a trading obligation for shares and hence a higher significance of the category of systematic internalizers (SI),
- the changes in the segment of dark pools due to volume caps,
- the new requirements for algorithmic and high frequency trading,
- the expansion of the transparency rules in force, so far only applicable to shares, to equity-like instruments, bonds, structured finance products, emission allowances and derivatives,
- the implementation of a trading and a clearing obligation for derivatives,
- the new category of trading venues: OTF (Organized Trading Facility).

The trading obligation for shares will change the scope and structure of today's OTC trading (Over-the-counter trading) and will lead to a transfer of many OTC transactions to regulated markets, MTFs (Multilateral Trading Facilities) and SIs. As a result, the relevance of the SI category which is comparatively rarely used so far, will increase considerably. Broker crossing networks, i.e. the matching of incoming orders in an internal dark pool of a(n) (investment) bank, will in its present form not survive in share trading. These platforms must be transformed to the regulatory format of an MTF or a SI. Here, the industry, primarily the large investment banks, will again be very creative to enable their important clients, such as investment fund companies, to continue the execution of large volumes outside the public markets and thereby to preserve their business model. Some large investment banks already announced to trade bonds, derivatives, shares and exchange traded funds on a new platform going forward, hence, to offer services as SI.

In contrast to broker crossing networks, dark pool-trading on regulated markets or MTFs, which significantly gained importance during the last years, has not been banned entirely. Regulated dark pools, which are offered by exchanges and MTFs, will likely change significantly due to the implementation of caps for dark pool transactions though. Many market operators search for ways to still meet the request to execute volumes in dark pools after the implementation of the double volume caps of 4 percent per market and 8 percent across markets. There are two main strategies to achieve this aim: firstly, the development of new dark pool models for very big transaction blocks, which can still be executed via dark pools without being taken into account for the volume cap calculation; and secondly, via recurring auctions, which likewise cannot be charged against the caps.

In addition, the trading and clearing obligations will have severe consequences for derivatives trading. Going forward, all OTC derivatives that are subject to the clearing obligation of the European Market Infrastructure Regulation (EMIR) and for which sufficient liquidity exists, have to be traded on regulated markets, MTFs or OTFs. The significant reduction of OTC trading goes hand in hand with an increasing share of regulated, supervised and transparent trading platforms.

The facilitation of interoperability between Central Counterparties (CCP) for the clearing of shares and bonds has already been defined as a requirement in EMIR. MiFID II, or rather MiFIR, regulates the non-discriminatory access between CCPs and markets in both directions in general. This equally includes exchange-traded derivatives. The current market structures of exchange-traded derivatives, which are characterized by a close interlocking between the trading platform and the clearinghouse – not least because of risk management considerations –, will break open and undergo a substantial reorganization. New trading platforms and clearing providers could enter the market and exacerbate competition. In this event, regulators and supervisory authorities should ensure that this will not result in an increase of

systemic risks and a functional impairment of the European derivatives markets. This was already taken into account in relation to exchange-traded derivatives by the transitional arrangements for clearinghouses in early January 2018.

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- Peter Gomber: The German Equity Trading Landscape (<https://safe-frankfurt.de/de/policy-center/publikationen/detailsview/publicationname/the-german-equity-trading-landscape.html>), SAFE White Paper No. 34

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