CNMV comments on certain aspects of MiFID II in the context of the public consultation launched by the European Commission in February 2020

18 May 2020

The European Commission (EC) launched an open public consultation on 17 February 2020 to gather stakeholders' views on the experience of two years of application of MiFID II/MiFIR and to seek views from stakeholders on technical aspects of the current MiFID II/MiFIR regime.

This note contains comments made by the CNMV (the Spanish National Securities Market Commission) on a few selected aspects of the consultation which relate to investor protection[1], trading venues and trading of financial instruments.

I. Inducements[2]

It should be noted that in Spain a significant portion of firms' income for the provision of investment services or for carrying on ancillary activities comes from inducements (mainly rebates paid by management companies or other product manufacturers, often from the same group, to banks or investment firms) and firms have just adapted to the new MiFID II inducements regime. It is interesting to note, also, that Spanish legislation is stricter in this field than others that also allow inducements in the context of services other than portfolio management and independent advice: it only accepts the three specific types of enhancements of the service mentioned in the MiFID II Delegated Regulation and contains a specific provision to avoid circumvention of the rules within financial groups through "vertical integration" schemes.

Having said this, along the lines of ESMA's recent Technical Advice on inducements and costs and charges disclosure requirements under MiFID II, **the CNMV would be supportive of an assessment of the possible introduction of a complete inducement ban for all retail products across the Union, provided that** (this is very important) **the prohibition would apply not only to MiFID products but also to MiFID-like products, such as investment-insurance instruments** in order to ensure the necessary level playing field.

It is fair to say, in any event, that a complete inducement ban, at this stage, would have a strong impact on many firms' business models. For this reason, in line with the aforementioned Technical Advice from ESMA, the assessment should be sufficiently deep and granular, comprising aspects such as the impact that the MiFID II inducements regime has already had on the distribution of retail investment products across the Union, taking

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[1] Section II (page 32) of the EC Public Consultation.

[2] Questions 49-50.1 of Section II (pages 48-49) of the EC Public Consultation.

into account the different distribution models, and the risks and potential undesired consequences linked to a ban.

If the decision were to substantially maintain the current regime, we would be **against any kind of bureaucratic and burdensome approach** based on strengthening firms' record-keeping obligations (obliging them to record information such as the amount spent to enhance the service by client or category of clients, the moment in time when the amounts received as inducements were applied, etc.) or imposing obligations like the use in full for the benefit of the client all third-party payments within a certain period (as investment firms are not-for profit organisations). These types of requirements would only represent additional administrative and operational burdens for the firms, which would have to develop procedures, controls and systems to apply them, with no meaningful benefit from a policy perspective, and increase the supervisory work of competent authorities in respect of areas that do not deserve special attention.

On the contrary, we would be supportive of possible alternatives to make the current regime more effective. The focus should be to ensure that **in the case of inducements, firms really have to implement meaningful and significant enhancements to the quality of the service** and that **the enhancements are sufficiently relevant taking into consideration the size of the inducement concerned**.

For this purpose, the Commission might consider the possibility of: (i) **closing the list of possible types of enhancements**, not permitting enhancements other than those specifically mentioned in the MiFID II Delegated Regulation; and (ii) introducing rules to avoid easy ways of circumventing the MiFID II inducements regime. This is the case of **"vertical integration practices"** between banks and product providers (typically investment fund management companies) belonging to the same group: banks do not receive as remuneration for their distribution activity any explicit inducement or rebate, or receive lower amounts than normal, and they make up for this by receiving more dividends. These kinds of schemes should be expressly considered as an inducement subject to the MiFID II regime. As mentioned above, we have addressed this issue in our jurisdiction and the application of the relevant rules has not raised any significant problems neither for the industry nor for the CNMV as supervisor thus far.

We would also like to draw the EC's attention to the treatment of **placing and underwriting fees** in the context of the inducements regime. In our view, monetary payments from the issuer or seller in the context of intermediation services (pure or accompanied by non-independent advice) provided in relation to an **IPO** or in general to **equity offerings to retail investors** (let alone to **professional investors**) **should be expressly excluded from the inducements regime**. These kinds of inducements are part of the DNA of IPOs, which are by definition one-shot and unique transactions subject to a specific and quite demanding transparency regime (prospectus, etc.). Furthermore, a restriction in this sense of the scope of the inducements regime would be an interesting measure in the context of the relaunching of the CMU project, which aims at reinforcing equity markets in Europe.

II. Client profiling and classification[3]

The CNMV does not consider that a new category of clients (intermediate between retail and professional investors) is required as we have not identified any issue or shortcoming in the

[3] Sub-Section 3 (Questions 40-45) of Section II of the EC Public Consultation (page 41).

current classification regime. Moreover, it would add further complexity to the current MiFID II regime, which already allows certain more experienced or sophisticated clients to ask to be treated as professional clients.

Nonetheless, the CNMV believes that the EC could work on the general issue of the possible overload of information with the aim of preventing the provision of unhelpful information to clients and on a better calibration of the information to be provided to the different categories of clients. In this regard, the CNMV is supportive of a **reduction of information on costs and charges for professional clients** (please see first indent of section XI below).

III. Investment services and activities

The traditional activity of matching or crossing transactions on behalf of clients may have a different status depending on the country of the Union, i.e. some authorities might understand that it is a simple investment service and others might consider that it is a multilateral activity that should require a license to operate as a trading venue (MTF or OTF).

The review of MiFID II should try to provide more clarity in this area in order to limit the regulatory arbitrage among the different jurisdictions.

IV. Article 2 exemptions: application of MiFID to non-exempted activities

The review of level I (L1) should provide clarification on the consequences of the application of MiFID to the non-exempted activities of EU residents (Article 2 MiFID II). Through level III, ESMA has concluded that non-exempted activities (e.g. DEA, HFT) always require a MiFID II license in order to be carried on, and therefore, should be performed exclusively by investment firms or banks. However, this approach might create a competitive disadvantage for EU entities vs third country legal or natural persons. Legal certainty at level I should be beneficial.

V. Unbundling

It seems clear that the unbundling regime under MiFID II is significantly negatively affecting the amount and probably also the quality of the research available to portfolio and fund managers, especially the research on small and medium-sized listed companies, which is particularly concerning in the current macroeconomic climate and in the context of the relaunching of the CMU project. A typical case in which a measure that is apparently flawless - on this occasion from the point of view of transparency and fair management of conflicts of interest - has counterproductive implications from other perspectives that may deserve the same or even more attention: access to the markets, and ultimately to financing under better conditions, of SMEs; existence and development of active local investment firms, which help to enrich the financial ecosystems; quality of management (as managers tend to buy less research and the research is of poorer quality), etc. In addition, in this case the measure is also prompting new modalities of the service, like issuer sponsored research, which also raises problems in terms of conflicts of interest.

The problem should definitely be analysed in depth and with our minds open even to a radical reconsideration of MiFID II on this point.

One alternative could be to give firms the possibility of opting out, maybe by imposing on those who opt out of the obligation of specifically informing clients of their decision and to justify from time to time (e.g. on a yearly basis) in a written report submitted to the board (or sent to the relevant supervisory authority) that the extra costs linked to the payment of higher intermediation fees correspond to valuable research and have been borne by the clients in general terms in an equitable manner.

VI. Market structure

The MiFID II market structure regime provides for an intended fragmented trading environment, which has been deemed positive in terms of competition. However, this fragmented environment entails some **challenges in terms of depth of liquidity, reliability of the price formation process** and fair competition.

Additionally, there are areas where keeping a **level playing field among systematic internalisers (SIs) and trading venues (TVs)** is difficult. In general, the SI regime has created difficulties for both investment firms being obliged to qualify as SIs and for market participants in terms of access to quotes, as well as transparency to the rest of clients and to the general market.

In particular, regarding the **algo-trading regulatory package**, we consider that a review of the mandatory market-making regime (both agreements and schemes) is necessary, in order to ascertain whether the regime is achieving in practice the objectives pursued by legislators. The obligation of entering into an agreement with a trading venue when an investment firm is engaged in algo-trading is perceived as a disincentive for market participants. In addition, the obligation for trading venues to maintain market-making schemes in liquid instruments has been controversial.

In general we consider that the market structure regime could be simplified and trading through trading venues should be promoted with the objective of creating deeper pools of liquidity.

VII. Trading obligations: shares (STO) and derivatives (DTO)

Excessive fragmentation might be damaging price formation and it is doubtful whether it has brought about a reduction in the overall costs for investors. **Higher trading volumes should be executed on trading venues** for various reasons, such as the protection provided by non-discretionary rules for trading, transparency of the activity, price formation reinforcement and efficiency in terms of trade reporting.

The emphasis should be placed on increasing the number of instruments and transactions subject to STO and DTO. Also, the role of SIs as eligible execution venues for the purposes of the STO should be reviewed if a level playing field cannot be ensured in practice.

VIII. Transparency

Although the objective of MiFID II was to bring more transparency into financial instruments trading, this objective has not been achieved, mainly due to the complexity of the transparency regime. The main concerns are: i) the extended use of waivers for both equity and non-equity instruments; ii) the uneven situation between trading on-venue or through SIs; iii) the lack of harmonisation in the use of deferrals and their length; iv) the challenges posed by financial innovation (usually oriented to more dark trading); and v) the concept of traded on a trading venue for OTC derivatives.

The increasing lack of representativeness of price forming liquidity pools is a concern. During the ongoing COVID-19 crisis, the reduction in liquidity and the scarce depth of lit order books have negatively influenced the volatility spikes. It is detrimental for market integrity that only around 20% of the volume traded in equity instruments could be contributing to the price forming and discovery process while the rest of the trading takes the price as a reference for waivers, pegged orders, SI quotes, etc.

In equity instruments, trading in lit trading modes should be reinforced. The average daily turnover in Europe is probably below €50,000 for half of the outstanding 27,000 instruments. The trading in lit order books is likely to be between 20-40% of the total where contribution to the price forming process of the SI activity is very limited. These figures reveal the weakness of today's price forming mechanisms.

The DVC system has limited dark trading to a certain extent for the most dramatic cases where the percentage of dark trading under the reference price waiver (RPW) and the negotiated trade waiver (NTW) stood at levels above20-40%. However, it has been proved inefficient to force the volume subject to the caps to be driven to lit order books (such volume has been kept dark through the large-in-scale waiver).

The volume conveys information to the market and that volume should contribute to the price forming process. **Trading away from the lit trading systems should be limited to large-in-scale transactions and for an exhaustive suite of transactions**. The **LIS thresholds should be** raised. Also, situations where a LIS threshold is set, for instance at €15,000 (as a result of the low ADT or AVT of the instrument), should be avoided through a minimum floor for LIS.

Regarding **non-equity instruments**, **the overlapping situation created by the exemption of the size specific to the instrument (SSTI) and the large-in-scale (LIS) waiver must be reviewed**. On the other hand, the extensive use of the illiquid waiver should be reviewed as transparency is again scarce. The post-trade transparency regime should be harmonised and, additionally, the length and possible combinations of deferrals should be reduced as much as possible.

Systematic internalisers perform the role of market makers in the OTC trading environment. However, market makers trading on-venue are subject to stricter requirements. This could be a starting point to **aligning obligations of market-making activities OTC and on-venue**.

The non-equity transparency regime is massively overcomplicated. As an example, the difficulties to perform the calculations of trading data for derivative instruments at EU level prevents the Systematic Internaliser MiFID II regime for derivatives from kicking off.

A key reform to this framework could be the **replacement of the dynamic calibration approach for a static one per class of instrument** where the re-calculation has proved that it is less necessary and burdensome. The complexity of the calculations and the effort in data management does not compensate the possible advantages (if any), and in particular on instruments where illiquidity is easily observable.

To sum up, in our view, **the whole regime requires simplification**. It has been demonstrated that, to date, there are even areas where the framework has not even been implemented. The general rule of transparency should prevail over the exemptions, which should be formulated around the use of the LIS waiver.

IX. Data

Apart from a small number of big players, it seems that the end users of information have not leveraged from the information provided by the new regime. This situation is mainly caused by the fragmented nature of information; the lack of harmonised formats and the cost and complexity of access to several sources.

In the absence of a definition of the term 'transaction' under the MiFID II/MiFIR framework, the data quality of trade reporting is affected by misreporting. In this regard, **a clear**

definition of transaction for the purposes of trade reporting is warranted.

At a more technical level, **SIs should be subject to the same pre-transparency rules currently applicable to trading venues**, ensuring that the information about quotes is adapted to formats and contents prescribed technically through level II; this would facilitate the integration of SIs' quote information into other information systems.

Additionally, the fragmented nature of trading in financial instruments gives rise to a need for market participants to manage more information from different sources. It is clear that this entails a **necessary consolidation of information** and legislators should work not only on contents but also on **formats and common presentation of the information**. This may be contested by the providers of information as it implies changes in the current way information is disclosed, but in the absence of that harmonisation, complexity and cost might constitute a barrier for many market participants.

X. Commodity derivatives

The commodity derivatives market is still a broker-based trading activity where the role of trading venues is less relevant and there is a strong resistance to change. The issues identified in commodity derivatives relate to predominance of OTC trading and the passive role of trading venues (pre-agreed transactions are only sent to the trading venue for registration); position limits, a regime which is detrimental for smaller trading venues (which have less liquidity and therefore lower thresholds), and a scope of contracts too wide for position limits.

The regime could be simplified by identifying a limited number of critical contracts where position limits are really necessary and concentrate the supervisory focus on them.

The current paradigm of trading of commodities through brokers and their clients in compartments through a single unauthorised electronic platform should be opened to a more all-to-all trading approach through organised and licensed trading venues. This could be addressed through the integration of the critical or most liquid contracts into **a trading obligation** and the recognition of the MiFID II trading market structure under EMIR by acknowledging the existence of **MTFs and OTFs**.

XI. Other possible amendments

- Regarding costs and charges disclosures under Article 24(4) MiFID, we believe that the applicable regime in this area should allow for more flexibility when applied to professional clients (both professional clients per se or upon request).

  In our view, a full opt-out regime for intermediation services makes sense, but also to partially extend the possibility of an opt-out for portfolio management and investment advice services (e.g. only to ex-ante information or to ex-ante and ex-post information but maintaining for professionals the annual reporting on costs and charges).

- Regarding suitability assessments under Article 25(2) MiFID, we consider excessive that these assessments have to be repeated every time an investment decision is made. Professional investors should be able, for instance, to sign up to an "investment policy statement" with their advisers which sets out investment objectives and constraints and only requires renewed suitability testing when these objectives or constraints change.

- Regarding MiFID Article 24(4) requirement that ex-ante information material be delivered before a trade is executed, some amendments could be included in order to facilitate the rapid conclusion of a transaction. In the case of telephone trading, where a transaction is carried out by telephone at the request of the client and it is not possible to provide the ex-ante costs disclosures in due time before executing the transaction, as generally required for any information, it is proposed that the costs disclosures may be provided immediately after the transaction is concluded. In addition, we agree that, when information must be provided in a durable medium, the provision of the information by means of electronic communications shall become the default option.

- **Best execution reports required under MiFID and its delegated rules.** We consider it reasonable to explore the simplification of the best execution reporting regime to make it more meaningful and less burdensome for intermediaries. This is valid not only for investment firm reports but also in respect of trading venues. In particular, the lay-out of trading venue reports on the quality of execution of transactions (CDR 2017/575) is massively over-complicated and should be simplified in order to achieve its purpose and reduce the burden for trading venues and investment firms).

- Regarding **governance requirements under Article 16(3) MiFID**, we consider that they should be confined to complex products.

- **We agree with removing "paper" as the default mode for transmitting client information** and various recurrent reports required under Articles 24(4) and 25(6) MiFID.