

AFM: Impact analysis MiFID II

May 2020

Introduction

MiFID II is currently being reviewed at the European level by the European Commission and ESMA on the basis of the review articles in level 1 (article 90 MiFID II and article 52 MiFIR). ESMA has submitted the first final reports (MiFID II review reports) to the Commission, other reports are in the consultative or drafting stage. The Commission has launched a consultation from February 18 until May 15 2020 on the review of MiFID II, with the aim of submitting a legislative proposal to the Council and the European Parliament (EP) in the second half of this year.

Against this background, the AFM decided last year to start an internal analysis on the impact of MiFID II. Our analysis was drafted on the basis of desk research, interactions with stakeholders (including a roundtable), data analysis and the supervisory experience with MiFID II for the first two years. The aim of our analysis was to make policy recommendations for any changes in the regulatory framework of MiFID II (level 1 or level 2), by making suggestions for further ESMA guidance at level 3 and for further supervisory convergence by ESMA members. We discuss our main conclusions in this document for equity, commodities and investor protection. We intend to cover fixed income in a subsequent publication. In a technical annex to this note, we include a table with our proposed amendments to level 1 and 2 which are based on our main conclusions.

Equity

Central underlying themes are whether transparency has increased sufficiently and how the market structure has changed, as a consequence of MiFID II. Our analysis relies in part on the ESMA consultation paper on equity transparency that was published on 4 February 2020.¹

Liquidity

We observe a couple of trends in the liquidity of the equity markets. Intraday liquidity is moving towards end-of-day auctions due to, amongst others, ETF trading seeking to follow the closing price. As shortening of the trading hours may benefit the liquidity during the trading day, we are sympathetic to the idea². Trading has become more fragmented across venues, with systematic internalisers (SIs) taking a larger part of the volumes. The AFM supports policy measures that will further align the level playing field between trading venues and SIs.

Data consolidation and the price of market data

Our discussion with stakeholders on data consolidation and the price of market data revealed that a large part of market participants view a real-time post-trade Consolidated Tape Provider (CTP) as an essential part of the CMU. There are, however, some practical issues concerning the establishment of a 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

¹ MiFID II/ MiFIR review report on the transparency regime for equity and equity-like instruments, the double volume cap mechanism and the trading obligations for shares.

² As seen from the perspective of MiFID II. There may be other aspects that influence the final AFM view on the current Euronext consultation on the shortening of trading hours.

potential to greatly improve transparency by aggregating information from increasingly fragmented markets. Whilst AFM is supportive of establishing a real-time post-trade 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 enforcements.

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.

Pre-trade transparency, waivers and the double volume cap

Waivers for pre-trade transparency can be useful to bring transactions on venue, in particular the Large-in-Scale waiver (LIS). However, the waiver structure is complex yet not easy to improve. The double volume cap (DVC) has very few supporters. It appears over-engineered and not achieving its purpose. AFM does not support limiting the available waivers to the LIS and order management facility (by eliminating the reference price and negotiated trade waivers), but does support simplifying the DVC by eliminating the 4% threshold at the level of individual trading venues.

Algo trading and HFT

Both exchanges and trading firms (trading on own account) claim that RTS 6 on market making (that aims to enhance liquidity in the market) works and that liquidity is indeed provided. Where liquidity provision is limited, this is likely to be due to other regulation (e.g. capital requirements) as opposed to MiFID II. The influence of HFT firms on the decline of intraday liquidity in the 'lit' is difficult to measure. Although some market participants, including the buy-side, indicate they are less willing to trade due to HFT presence, there are many other factors as well, such as: liquidity in the closing auction, bilateral trading by institutional investors under waivers, and retail moving to zero-commission brokerage. The impact of some of the measures taken by venues to counteract low latency advantages, such as speedbumps and periodic auctions, is a point for further research.

From the discussion with a variety of market participants, it appears HFT firms are acting as genuine liquidity providers, playing a valuable role in the market structure and price formation process. We are therefore not necessarily a proponent of the introduction of speedbumps or similar forms of barriers that could hamper the manner in which trading information is equally accessible to different types of participants, unless there are real concerns that a level playing field is impacted by low latency advantages of HFT firms.

Commodities

We investigated the impact of the introduction of position limits, position management controls and pre-trade transparency requirements for trading venues that trade in commodity derivatives in the

Netherlands. We performed an internal analysis on position data obtained through CPRS (Commodity Position Reporting System) and EMIR. In addition, a trading venue and major market participants trading on the trading venue in electricity and gas derivatives were interviewed to gain more insight into the effect of the implementation of position limits, position management controls and pre-trade transparency.

Position limits

The MiFID II position limit regime has been working reasonably well for well-developed benchmark contracts characterized by a large number of different types of active trading firms and a substantial amount of open interest. The AFM suggests to review and amend RTS 21 for less liquid contracts to capture the MiFID II objective of having position limits which prevent market abuse. The AFM also acknowledges that the scope of the position limit regime should be narrowed down to focus on benchmark physically settled contracts only. Limiting the scope of the position limit regime to specific contracts would request a level 1 change.

Position management

The impact of the position management controls on the commodity derivatives market has shown to be limited. The AFM supports to add measures for trading venues to aggregate positions under common ownership to have a more effective tool in ensuring fair and orderly trading and to prevent market abuse. It will help in increasing the effectiveness of the position management regime. This would require a level 1 change. The AFM would be supportive of supervisory convergence to generate a level playing field. Trading venues could inform their NCA on how they have executed the position management controls and through a supervisory briefing compliance could be ensured.

Pre-trade transparency for commodity derivatives

The pre-trade transparency regime for commodity derivatives shows clear issues regarding the implementation. The methodology for calculating LIS thresholds generates counterintuitive results. The AFM suggests that the pre-trade transparency regime needs a more calibrated approach to transparency. Meaning that the sub-asset classes need to be more granular and the threshold methodology better aligned with the underlying commodity market. This requests a level 2 change of RTS 2.

Investor protection

Overall, the MiFID II regime has enhanced retail and professional investor protection throughout the European Union (EU) and the AFM has therefore welcomed the regime. The investor protection rules in MiFID II and MiFIR comprise of a variety of subjects. Some of them were new sets of rules, such as product governance and costs and charges, while others already existed in MiFID I. The different topics discussed below will focus on the MiFID II norms and are based on supervisory experience of the last two years.

Product governance

Prior to MiFID II's implementation, there were already product governance and oversight (POG) requirements applicable in the Netherlands to certain firms and with regard to specific types of products. But with the introduction of MiFID II the POG requirements also became applicable to a wider scope of products and firms throughout the EU. Furthermore MiFID II regulates all stages of the products or services to ensure that firms which manufacture and distribute financial instruments and structured deposits act in the clients' best interests. This has led to better overall investor protection. Product governance continues to be a priority of the AFM.

We see that investigated firms have made significant improvements in applying the POG rules. Target market assessments have improved being accommodated by substantiations and reasoning. Also distribution strategies of the investigated firms, especially when looking at the execution only and appropriateness regimes, are improved, taking into account the ESMA target market categories. Overall, in our opinion POG leads to improved investor protection. As the POG rules have an open character, they are meant to foster internal discussion on firm level over the correct target market definition and how to align the distribution strategy with this. At the same time, the open character can also sometimes lead to uncertainties for firms. Especially, at the start it was not clear to some firms that also for the appropriateness regime firms need to specify the type of client for whose needs, characteristics and objectives a financial instrument is compatible or not. To prevent uncertainty and to improve a level playing field, we would support to legally implement such clarification.

Costs and charges

The AFM considers the costs and charges provisions in MiFID II an important improvement enhancing cost transparency. This enables investors to make better informed investment decisions. However, additional work is needed on national level in order to achieve full compliance with these requirements. From thematic reviews conducted under both investment firms, providing service to retail investors and firms providing service to professional investors, the AFM concluded that the ex-ante disclosure was not yet up to standard.

On EU level, more work is needed in order to achieve supervisory convergence. One way to achieve this convergence is already under way as a result from the public consultation held by ESMA in 2019. In the resulting recommendations to the Commission, ESMA recommends to include some level 3 guidance into the delegated acts.

One of the specific observed implementation problems for professional investor protection was the ex-ante cost disclosure where it concerns telephone orders. If time is of the essence in executing the order for the client, providing the ex-ante cost disclosure on a durable medium prior to the transaction may not be in the client's best interest due to the corresponding execution delay. In ESMA's Technical Advice to the Commission it proposes that eligible counterparties and professional clients should be allowed to opt-out completely of the ex-ante costs disclosure requirements in the provisions of execution-only services. The AFM supports this proposed amendment.

Inducements

The MiFID II inducement rules were not a major change for the Netherlands due to the top-up regime already in place for retail clients. It goes without saying that the AFM has a preference for an EU ban on inducements. The ban on inducements reduces conflicts of interest for advisers/intermediaries while it increases competition between product manufacturers. This encourages the distribution of more cost-effective investment products to consumers. Therefore the AFM remains to be an advocate for the ban and will continue her efforts to promote the introduction of a ban similar to the Dutch ban. Such ban would also be in line with the Capital Market Union's (CMU's) goal 'to increase retail participation in the capital markets'.

The top-up regime does not apply to investment services provided to professional clients. The AFM has performed a thematic review on the impact of the MiFID II inducement rules on services provided to this type of clients. Based on the information received from the firms involved in the review, the AFM concluded that none of them received monetary benefits from third parties in relation to the provision of investment or ancillary services. Most firms did indicate that they received minor non-monetary benefits (MNMB), however the AFM observed that the definition of MNMB they applied was often too broad, exposing themselves to the risk of receiving inducements they are not allowed to receive when providing portfolio management or independent advice.

However, the inducement regime introduced by MiFID with the expected highest impact were the rules on the costs of research. In the AFM's thematic review, the AFM looked into the firms' compliance with these rules. The investigation showed that all investment firms paid for research. However, the AFM has not looked into whether the actual prices paid corresponded with the value of the material received.

Appropriateness

The AFM believes the current appropriateness provisions need at least two improvements. Firstly, the AFM believes the requirement for investment firms to obtain information about the (former) profession and level of education of every client should be removed. The AFM questions the added value of the information on education and profession since this information does not tell the firm whether or not the client has knowledge of the investment product or service.

Secondly, the exception to the provision that allows firms to warn the client the investment firm did not obtain the necessary information to assess the client's appropriateness should be withdrawn. In the opinion of the AFM this exception does not effectively serve the purpose of the appropriateness test. AFM observed that this warning is sometimes set as a default so it is used to avoid the hurdle in the order flow having to ask the client for the relevant information about their knowledge and experience. For this reason, the AFM believes the provision should be amended. Investment firms should be obliged to conduct an appropriateness test (for complex products) even if a client is unwilling to provide the requested information. Consequently, the provision should prescribe the obligation for the investment firm to obtain the requested information about the client's knowledge and experience as a condition for a client to proceed with the investment service or relevant order. This approach would contribute to consistency with the suitability assessment, where such an exception is not

provided for. In conclusion, the provisions on the assessment of appropriateness could use some improvements to make it more effective as a measure to protect investors in the execution only channel.

Product intervention (PI)

MiFID II gave the NCAs and ESMA the powers to restrict and prohibit products in the European markets. Through thorough preparation, ESMA was able to introduce its first PI measures on prohibiting Binary Options and restricting CFDs shortly after the introduction of MiFID II. The AFM followed with her own permanent national measure in May 2019 and was one of the first NCAs to introduce one.

The AFM, together with several other NCAs, asked the Commission, via ESMA, to amend ESMA's PI powers with regard to temporary measures into permanent PI measures. A first achievement is noted in the ESA review as the temporary measures of ESMA will be extended from three to 18 months. However, for convergence and effectiveness reasons AFM still supports to translate ESMA's PI powers from temporary measures into permanent measures.

In line with ESMA's technical advice on product intervention, the AFM would like the Commission to further clarify the application of national product intervention measures to firms acting on a cross-border basis. It is important to clarify the distribution of responsibilities of supervision and enforcement of NCAs of the home and host Member States in respect of those measures. This is especially relevant when NCAs from different Member States take overlapping or different product intervention measures.

Annex: Proposed amendments at level-1 and level-2.

Topic		Article	Text	Amendment
Position Limit regime	Level 1	Article 57 (4) of Directive 2014/65/EU	<i>A competent authority shall set limits for <u>each contract</u> in commodity derivatives traded on trading venues based on the methodology for calculation determined by ESMA in accordance with paragraph 3. That position limit shall include economically equivalent OTC contracts.</i>	The scope of the position limit regime should be amended and the focus should be only on physically settled benchmark contracts. Therefore the AFM suggests to replace “each contract” with “physically settled liquid contract”.
Position Limit regime	Level 2	Article 15 (a) RTS21 (Article 57(3) (g) of Directive 2014/65/EU)	<i>for commodity derivatives traded on a trading venue with a total combined open interest in spot and other months' contracts not exceeding 10 000 lots over a consecutive three month period, competent authorities <u>shall set the limit of positions held in those commodity derivatives at 2 500 lots;</u></i>	The position limit regime has proven to be hindering the development of new products and further growth of existing less liquid commodity derivatives. Therefore the AFM suggests that new contracts and illiquid contracts should be out of scope of the position limit regime.

Position Management regime	Level 1	Article 57 (8) Directive 2014/65/EU	<p><i>Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives apply position management controls. Those controls shall include at least, the powers for the trading venue to:</i></p> <p><i>(a) monitor the open interest positions of persons;</i></p> <p><i>(b) access information, including all relevant documentation, from persons about the size and purpose of a position or exposure entered into, information about beneficial or underlying owners, any concert arrangements, and any related assets or liabilities in the underlying market;</i></p> <p><i>(c) require a person to terminate or reduce a position, on a temporary or permanent basis as the specific case may require and to unilaterally take appropriate action to ensure the termination or reduction if the person does not comply; and</i></p> <p><i>(d) where appropriate, require a person to provide liquidity back into the market at an agreed price and volume on a temporary basis with the express intent of mitigating the effects of a large or dominant position.</i></p>	The AFM supports to add measures for trading venues to aggregate positions under common ownership. This will increase the effectiveness of the position management regime.
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Pre-trade transparency regime commodity derivatives	Level 2	RTS 2 Annex III, Table 7.1	<p><i>The average daily notional amount (ADNA) and the average daily number of trades (ADNT) are set at the same level for all commodity derivatives (ADNA = EUR10M and ADNT = 10 trades).</i></p>	<p>The AFM suggests that the pre-trade transparency regime needs a more calibrated approach to transparency. Meaning that the sub-asset classes need to be more granular and the threshold methodology better aligned with the underlying commodity market and therefore should have different levels of ADNA and ADNT to determine if it is a liquid market.</p>
Costs and charges	Level 2	<p>MiFID II Delegated Regulation</p> <p>Article 50(9)</p>	<p><i>Investment firms shall provide annual ex-post information about all costs and charges related to both the financial instrument(s) and investment and ancillary service(s) where they have recommended or marketed the financial instrument(s) or where they have provided the client with the KID/KIID in relation to the financial instrument(s) and they have or have had an ongoing relationship with the client during the year. Such information shall be based on costs incurred and shall be provided on a personalised basis.</i></p> <p><i>Investment firms may choose to provide such aggregated information on costs and charges of the investment services and the financial instruments together with any existing periodic reporting to clients.</i></p>	<p>The AFM suggests a clarification should be added that, as firms are required to provide the actual costs incurred by the client in the ex-post costs disclosures, they should monitor the client's portfolio in a manner that allows to get as accurate as possible to the actual costs. As such, the day-to-day monitoring of client's portfolios should be the minimum standard if firms are to be compliant with their costs and charges requirements.</p>
Costs and charges	Level 2	<p>MiFID II Delegated Regulation</p> <p>Article 50(1)</p>	<p><i>Without prejudice to the obligations set out in Article 24(4) of Directive 2014/65/EU, investment firms providing investment services to professional clients shall have the right to agree to a limited application of the detailed requirements set out in this Article with these clients. Investment firms shall not be allowed to agree such limitations when the services of investment advice or portfolio management are provided or when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.</i></p> <p><i>Without prejudice to the obligations set out in Article 24(4) of Directive 2014/65/EU, investment firms providing investment</i></p>	<p>The AFM supports the proposal by ESMA that eligible counterparties and professional clients should be allowed to opt-out completely of the ex-ante costs disclosure requirements in the provision of execution-only services.</p>

services to eligible counterparties shall have the right to agree to a limited application of the detailed requirements set out in this Article, except when, irrespective of the investment service provided, the financial instruments concerned embed a derivative and the eligible counterparty intends to offer them to its clients.

Costs and charges	Level 2	MiFID II Delegated Regulation Article 50(10)	<i>Illustration shown.</i>	The AFM believes that the illustration only serves its purpose if it shows the effect costs have on the return over multiple years. Therefore, detailed requirements should be included in level 2 which prescribe that firms should use the recommended holding period of the portfolio or the product and should illustrate an expected return for the ex-ante disclosure. For the ex-post disclosure firms should be allowed to use the actual returns. While the discussion on further clarification on the elements of the illustration is ongoing, the AFM trusts that the long term effect of costs on accumulating returns is better presented when additional illustration is provided.
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Inducements	Level 1	Article 24 (7) and 24 (8) MiFID II		The AFM suggests to amend the mentioned article/ paragraphs in order to include a ban on inducements.
Appropriateness and suitability	Level 2	Article 55 (1) (c) Commission Delegated Regulation (EU) 2017/565 of 25 April 2016	<p><i>1. Investment firms shall ensure that the information regarding a client's or potential client's knowledge and experience in the investment field includes the following, to the extent appropriate to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved:</i></p> <p><i>(c) the level of education, and profession or relevant former profession of the client or potential client.</i></p>	The AFM questions the added value of the obligation to obtain the information on education and profession since this information does not help the firm to determine whether or not the investment product or service fits or suits the client. We suggest not to oblige firms anymore to always obtain this information.
Appropriateness	Level 1	Article 25 (3) MiFID II	<p><i>Where clients or potential clients do not provide the information referred to under the first subparagraph, or where they provide insufficient information regarding their knowledge and experience, the investment firm shall warn them that the investment firm is not in a position to determine whether the service or product envisaged is appropriate for them. That warning may be provided in a standardised format.</i></p>	The AFM believes this provision should be adjusted. Investment firms should be obliged to perform an appropriateness test (for complex products) even if a client is unwilling to provide the requested information.
Product Intervention	Level 1	Article 40 MiFIR	<p><i>1. In accordance with Article 9(5) of Regulation (EU) No 1095/2010, ESMA may, where the conditions in paragraphs 2 and 3 are fulfilled, temporarily prohibit or restrict in the Union:</i></p>	The AFM suggests that ESMA should also have permanent intervention powers. These could be added to article 40 or in a separate article.