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EU FINANCIAL GOVERNANCE AND TRANSPARENCY REGULATION: A TEST FOR THE EFFECTIVENESS OF POST CRISIS ADMINISTRATIVE GOVERNANCE

I. TRANSPARENCY REGULATION AND EU FINANCIAL GOVERNANCE: WHY IT MATTERS

X.01 It is axiomatic that, in the wake of the far-reaching crisis-era reforms which took place over 2008-2014, the 'single rulebook' which now governs EU financial markets has become wider, deeper, more technical, and more complex, and that the EU's related ascendancy over its Member States with respect to financial market rule-making has become almost total.[1] The scale of this recasting of EU financial market regulation is well-illustrated by the new trading transparency regime[2] which will apply to EU financial markets once the Markets in Financial Instruments Directive II 2014 and Markets in Financial Instruments Regulation 2014[3] apply to EU financial markets in 2019.[4] As noted in section II below, transparency rules govern the disclosures on trading activity which must be made available by those market actors subject to transparency requirements; these actors are typically trading venues, in respect of multilateral trading on organized venues, and banks/investment firms of various types, in respect of bilateral, off-venue trading between counterparties.

X.02 The new trading transparency rules, which are contained in the MiFIR Regulation and which will accordingly apply without further implementation by the Member States, exemplify

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[1] For discussion see, eg, David Howarth and Lucia Quaglia, 'Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks, and 'Completing' Economic and Monetary Union' (2013) 51 *Journal of Common Market Studies* 103 and Eilís Ferran, 'Crisis-driven Regulatory Reform: Where in the World is the EU Going?' in Eilís Ferran, Niamh Moloney, Jennifer Hill, and John C. Coffee, *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press, 2012) 1.

[2] For discussion of the new transparency regime see Niamh Moloney, *EU Securities and Financial Markets Regulation* (Oxford University Press, 2014), chapter V; Guido Ferrarini and Paolo Saguato, 'Reforming Securities and Derivatives Trading in the EU: From EMIR to MIFIR' (2013) 13 *Journal of Corporate Law Studies* 319; and Nils Clausen and Karsten Sørensen, 'Reforming the Regulation of Trading Venues in the EU under the Proposed MiFID II – Levelling the Playing Field and Overcoming Market Fragmentation' (2012) 9 *European Company and Financial Law Review* 275.

[3] Directive 2014/65/EU [2014] OJ L173/349 (MiFID II) and Regulation (EU) No 600/2014 [2014] OJ L173/84 (MiFIR).

[4] At the time of writing, the co-legislators are expected to agree to an extension of the current date of application of MiFID II/MiFIR from January 2018 to January 2019.

the recent crisis-era recasting of EU financial markets regulation in a number of respects. First, they take the form of a Regulation and will apply directly in the Member States, thereby delivering maximum harmonization in this area. National discretion, save with respect to various waivers, has been removed. So too, accordingly, has the need for local consultation on and impact assessment of the new transparency regime;[5] there are, accordingly, only very limited corrective mechanisms available at national level (save for the various waivers available) through which regulatory error or unintended consequences can be addressed. Second, and by stark comparison with the transparency regime contained in the precursor Markets in Financial Instruments Directive I 2004 (MiFID I),[6] the new transparency rules apply to a significantly wider range of financial instruments and derivatives. In a major change, the new rules apply to non-equity asset classes as well as to the equity asset classes covered by MiFID I.[7] In addition, a materially wider range of market actors and venues will be subject to the new rules; in particular, a new form of trading venue classification, the Organized Trading Facility, is deployed by MiFIR to attach non-equity transparency rules to those trading venues on which standardized derivatives have traditionally traded.[8] Third, the new transparency regime is significantly more detailed and granular than the precursor MiFID I regime. The MiFIR transparency regime will ultimately be composed of a series of components: the level 1 rules set out in MiFIR[9] - which contains many examples of the highly detailed legislative rule-making which is somewhat at odds with the high-level, norm-setting quality associated with level 1 but which is a feature of crisis-era level 1 rule-making; an administrative rule-book of vast scale - composed of level 2 Binding Technical Standards (BTSs), adopted by the Commission but proposed by the European Securities and

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[5] The UK Financial Conduct Authority (FCA), which is charged with much of the MiFIR implementation process, has decided, given the direct applicability of MiFIR, not to engage in consultation on much of MiFIR and to carry out only a limited impact assessment, directed to the small number of areas where there a degree of national discretion: FCA, ‘Markets in Financial Instruments Directive II Implementation, Consultation Paper I’, CP 15/43 (2015) 8.

[6] Directive 2004/39/EC OJ [2004] L145/1.

[7] ESMA has described the new regime as encompassing ‘an exponential increase in the number of instruments under pre- and post-trade transparency obligations’: ESMA, ‘Note on MiFID/MiFIR Implementation: Delays in the Go-Live Date of Certain MiFID Provisions’, ESMA/2015/1514.

[8] The UK FCA has noted that the introduction of the OTF classification means that ‘many transactions currently categorized as off-venue will come within a multilateral trading environment’ and that overall market transparency should accordingly increase: FCA, ‘Markets in Financial Instruments Directive II Implementation, Consultation Paper I’, CP 15/43 (2015) 15.

[9] The transparency regime is set out in MiFIR, arts 3-22.

Markets Authority (ESMA), and also composed of ‘standard’ level 2 administrative rules, adopted by the Commission and in relation to which ESMA provides Technical Advice; and a raft of soft level 3 guidance and similar measures, adopted by ESMA. The level 2 and level 3 elements of the transparency rulebook are still under construction. In September 2015 ESMA presented its lengthy proposals for BTSs on the transparency regime to the Commission.[10] Earlier in December 2014 ESMA presented the Commission with its extensive Technical Advice on the level 2 transparency rules which will not take the form of BTSs but which will be adopted by the Commission as standard level 2 administrative rules.[11] Fourth and finally, the new regime is characterized by a level of technical complexity which can confound all but the most expert. ESMA’s September 2015 proposed BTSs cover, for example, the empirical calculations governing when an interest rate derivative is liquid for the purposes of transparency regulation. [12]

X.03 In its design, detail, and breadth, the MiFIR transparency regime exemplifies recurring substantive features of the crisis-era reforms which have been extensively charted.[13] Accordingly, and given in particular that the new regime displays an intensely granular quality and is strongly characterized by immense technical complexity, it generates something of an existential challenge for the regulatory lawyer. How best to examine the MiFIR transparency regime?

X.04 It is beyond question that, functionally, the new transparency regime is of seismic importance to the EU financial market given its strong market-shaping quality. The delay to the application date of MiFID II/MiFIR from 2018 to 2019 is in large part being driven by the demands of the related implementation process, including with respect to the construction of the new systems required to ensure market compliance with the new transparency regime. But MiFIR-driven change is not likely to be only mechanical or operational in nature: the MiFIR transparency regime will bring fundamental changes to how trading in the EU takes place. Measures of a market-shaping orientation are, of course, not a new feature of EU trading market

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[10] ESMA/2015/1464 (ESMA September 2015 BTS Proposals)

[11] ESMA/2014/1569 (ESMA December 2014 Technical Advice)

[12] ESMA September 2015 BTS Proposals, 104-108.

[13] See, eg, on the alternative investment fund manager reforms Eilís Ferran, ‘After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU’ (2011) 12 *European Business Organization Law Review* 379.

regulation. As has been widely discussed in the literature, MiFID I was a classic market-shaping measure in that it sought to change EU market microstructure by using law to liberalize share trading in the EU and to reallocate the benefits of share trading from the major trading venues (which benefited from a 'concentration' rule which allowed share trading to be funneled to the major stock exchanges) and across a wider range of execution venues.[14] Like MiFID I, MiFID II/MiFIR also has market-shaping ambitions. But, and reflecting the crisis-era reform context and the related driving concern to increase transparency on market activity generally, it has a more prescriptive orientation, particularly with respect to share trading. Over the MiFID II/MiFIR negotiations, the European Commission and European Parliament sought to reduce the volume of over-the-counter (OTC) share trading, in part as EU transparency rules do not currently (under MiFID I) apply to such trading. This trading can, accordingly, take place 'in the dark' and not contribute to price formation.[15] While the Council adopted a more liberal approach to OTC share trading over the MiFID II/MiFIR negotiations, it was also concerned to ensure that trading in shares, to the extent possible, took place on open, transparent and regulated platforms.[16] The related political/institutional compromise on share trading, reflected in MiFID II/MiFIR, includes a requirement for all trading in shares to take place on organized venues (MiFID II Article 25): an investment firm must ensure that the trades it undertakes in shares admitted to trading on a regulated market, or traded on a trading venue, must take place on a regulated market, multilateral trading facility, systematic internalizer, or equivalent third country venue.[17] Only those share trades which are non-systematic, ad hoc, irregular and infrequent or are carried out between professional counterparties and do not contribute to price discovery are exempt from this requirement which seeks to move standard share trading on to organized trading venues.

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[14] From the extensive literature see, eg: Lucia Quaglia, *Governing Financial Services in the European Union. Banking, Securities, and Post-trading* (Routledge, 2010); Ryan Davies, Alfonso Dufour, and Brian Scott-Quinn, 'The MiFID: Competition in a New European Equity Market Regulatory Structure' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe. Corporate Law Making, the MiFID and Beyond* (Oxford University Press, 2006) 163; Barbara Alemanni, Giuseppe Lusignani, and Marco Onado, 'The European Securities Industry: Further Evidence on the Roadmap to Integration', in ibid, 199; and Guido Ferrarini and Fabio Recine, 'The MiFID and Internalisation', in ibid, 235.

[15] See, eg, the European Commission's Impact Assessment for the MiFID II/MiFIR proposals (SEC (2011) 1226, 36-37).

[16] Cyprus Presidency Progress Report on MiFID II/MiFIR, 13 December 2012, Council Document 16523/12.

[17] The different venue classifications are outlined in section II.

X.05 But the market-shaping effects of MiFIR may also take the form of unintended consequences. Chief among these is the potential generation of regulatory incentives to market-makers to decrease liquidity supply in the non-equity markets. There are accordingly contradictions within the MiFIR/MiFID II regime as much of the regime is otherwise directed to ensuring that the supply of liquidity from market-makers is appropriately managed by trading venues.[18] In particular, the new transparency requirements may increase the market impact/position risks carried by those supplying liquidity to the non-equity markets, increase their costs, and thereby create incentives to reduce dealing/liquidity supply activities. The new transparency rules are accordingly increasingly being associated with the creation of potentially significant and unpredictable market-shaping effects deriving from their potential to contract trading across a wide range of asset classes previously not subject to transparency regulation, and to generate, as a result, related risks to market liquidity (see section II below on the interaction between liquidity and transparency regulation).[19] The new bond market transparency rules, for example, may have unforeseen effects arising from the uncertain nature of their interaction with the wider market restructuring which is currently re-shaping bond market trading (this re-shaping is being driven by a range of factors, including the higher capital charges being imposed on market-making activities and the related movement by market-makers from principal to agency trading) and which is being associated with a thinning of bond market liquidity and with greater volatility.[20] A concern for bond market liquidity is beginning to seep into EU financial markets policy. The Commission’s September 2015 Capital Markets Union Action Plan, which is currently framing capital market policy development in the EU, notes market concern in relation to the risks to liquidity in secondary bond market trading, and the related risks to the EU economy arising from any related future contraction in the primary issuance market and in higher borrowing costs for firms. Although the Commission has asserted that the new MiFIR transparency regime should increase the attractiveness of the EU capital market, it has also committed to monitoring developments in this area.[21] MiFIR itself acknowledges the

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[18] MiFID II, eg, imposes new requirements on trading venues with respect to how they engage with market-makers and in relation to the obligations imposed on market-makers with respect to liquidity: MiFID II, art 48.

[19] For a recent assessment see ICMA (International Capital Markets Association), ‘The Current State and Future Evolution of the European Investment Grade Corporate Bond Second Market: Perspectives from the Market’, November 2014.

[20] See recently IOSCO, ‘Securities Markets Outlook 2016’ (2016) 30-37.

uncertainties associated with the new regime and supports related review: Article 52 requires that the Commission (currently by 2019 but this date is likely to move out), after consulting ESMA, report to the European Parliament and Council on the impact in practice of the new transparency regime.

X.06 The MiFIR transparency regime accordingly illustrates the extent of the market-shaping ambition of current EU financial market regulation, as well as its potential to operate as an agent of unforeseen effects. EU financial market regulation has, of course, long been (and continues to be) concerned with facilitative market-making/construction and liberalization, as is clear from the Capital Markets Union agenda.[22] But the market-shaping potential of EU financial market regulation is now immense - if as yet empirically uncertain. MiFIR forms part of a regulatory continuum which includes the 2013 Capital Requirements Directive IV/Capital Requirements Regulation,[23] which is reshaping banks' business models as it impacts on bank balance sheets and lending practices,[24] and the 2012 European Market Infrastructure Regulation,[25] which is restructuring the organization of derivatives markets in the EU. Empirical observation of the impact of MiFIR will accordingly be of acute importance, and the MiFIR transparency regime will similarly provide a rich data-source for analyses of a functionalist/law and finance orientation. The extensive scholarship which has followed from empirical observation of the impact of the MiFID I equity market transparency regime on equity markets in the EU[26] suggests

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[21] Commission, 'Action Plan on Building a Capital Markets Union', COM (2015) 468, 13-14.

[22] See further Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System' (2016) *European Law Review.*

[23] Directive 2013/36/EU [2013] OJ L176/338 (CRD IV) and Regulation (EU) No 575/2013 [2013] OJ L176/1 (CRR)

[24] For an early assessment see EBA, 'Overview of the Potential Implications of Regulatory Measures for Banks' Business Models' (2015).

[25] Regulation (EU) No 648/2012 [2012] OJ L201/1

[26] From the extensive discussions see eg: Bashir Assi and Diego Valiante, 'MiFID Implementation in the Midst of the Financial Crisis', European Capital Markets Institute Research Report No 6 (2011); Bahram Soltani, Huu Minh Mai, and Meriem Jerbi, 'Transparency and Market Quality: An Analysis of the Effect of MiFID on Euronext' (2011), available at http://ssrn.com/abstract=1833605; Valter Lazzari (ed), *Trends in the European Securities Industry* (Egea, 2011); and Giovanni Petrella, 'MiFID, Reg NMS and Competition Across Trading Venues in Europe and the USA' (2010) 18 *Journal of Financial Regulation and Compliance* 257. For a summary of the data see Guido Ferrarini and Niamh Moloney, 'Reshaping Order Execution in the EU and the Role of Interest Groups: From MiFID I to MiFID II' (2012) 13 *European Business Organization Law Review* 557.

that MiFIR will generate a powerful case study for examination of the relationship between law and markets.

X.07 From a more institutionalist perspective, the MiFIR transparency regime exposes the persistence of the deep-rooted political tensions which have long accompanied the EU single financial market project, and how political preferences continue to shape EU financial governance.[27] At present, these tensions and preferences can primarily be associated with the uneasy relationship between single market and euro-area financial governance, and with the resolution of sorts achieved by the February 2016 'New Settlement' for the UK within the EU.[28] But the current euro area/single market tensions are simply the most recent expression of persistent and entrenched political differences across the Member States as to how the single financial market should be governed and of the related institutional divergences which shape these differences.[29] In some respects, and particularly at level 2, the MiFIR transparency regime is almost scientific in its dependence on empirical data and assessment. In others, however, and particularly at level 1, it represents a classic EU 'hodge podge' of political compromises. In particular, the transparency negotiations witnessed serious clashes between those Member States more supportive of facilitating market preferences and concerned as to the market-shaping effects of extending transparency requirements, and those Member States concerned to extend transparency requirements and to ensure that as much trading as possible takes place on organized transparent venues. The clashes have left their mark on the waivers which are available from the transparency regime, and which became the battleground for both positions. Complex and often peculiarly granular in their design, the waivers represent the means through which compromise was achieved and particular national preferences in relation to market microstructure protected.

X.08 The focus of this short critique, however, is on the administrative governance implications of the new transparency regime. First, and with respect to supervisory governance, the MiFIR

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[27] For a recent example see Daniel Mügge, 'The Political Economy of Europeanized Financial Regulation' 20(3) *Journal of European Public Policy* (2013) 458

[28] Decision of the Heads of State or Government Meeting Within the European Council, 'Concerning a New Settlement for the United Kingdom with the European Union,' European Council Meeting, 18 and 19 February 2016 (EUCO 1/16), Annex 1.

[29] Initially charted in the Varieties of Capitalism literature and now assessed across multiple dimensions, including with respect to the extent bank-based economic systems incorporate market-funding mechanisms. See recently Iain Hardie and David Howarth (eds), *Market-based Banking and the International Financial Crisis* (Oxford University Press, 2013).

transparency regime certainly exemplifies the extent to which EU financial market regulation has become centralized and how the notion of a 'single rulebook' has become embedded within EU financial system governance. But it also deploys administrative supervisory governance strategies to entrench regulatory governance. Second, and with respect to regulatory governance, the MiFIR transparency regime exposes the extent to which, some eight years out from the financial crisis, the administrative governance system which supports the EU financial system may come under pressure with respect to rule-making. In particular, the MiFIR transparency regime generates important but potentially intractable challenges with respect to the ability of the current administrative process to revise and suspend rules nimbly.

X.09 This chapter first, however, considers the nature of transparency regulation, the distinctiveness of the EU's approach to transparency, and the main features of the MiFIR transparency regime.

II. TRANSPARENCY REGULATION AND EU FINANCIAL GOVERNANCE

1. The Purpose of Transparency Regulation

X.10 Transparency regulation governs the mandatory disclosure of the price, volume, and transaction information produced by trading venues and, under certain conditions, from bilateral trades between trading counterparties, and the availability of such disclosures to the market on a real-time basis. These disclosures, particularly in the equity markets, support price formation and, thereby, liquidity. But they also perform a number of related functions. In a transparent market-place, potential traders can see all the orders entering the market and the transactions already completed, and can accordingly monitor the execution process.[30] Transparency rules can also address fragmentation risk (which arises where trading in an instrument splits across multiple venues) as they 'tie together' execution data from different venues and support price formation, the pooling of liquidity, and the achievement of best execution. Transparency requirements have, in addition, a supervisory dimension: they support supervisors in monitoring the nature of trading and in detecting emerging risks, including with respect to market abuse, and, as they allow supervisors to monitor liquidity levels, market stability.[31]

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[30] See, eg, Ruben Lee, *What is an Exchange? The Automation, Management and Regulation of Financial Markets* (Oxford University Press, 1998) 256.