Nordic Securities Association

MEMO

Importance of aggregated publication

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It is important to balance the need of transparency and liquidity, in particular for smaller non-equity markets dependent on market makers/SIs. Our view is that restrictions of aggregated publication on level 2, as proposed by ESMA in its Discussion Paper, must be avoided since it would harm the liquidity in small government bond markets and thereby increase the costs for managing the national debt. The proposal also limits SMEs possibility to access and get funding at the capital markets. Thereby the proposals make it difficult to achieve the Commissions' vision of creating a Capital Markets Union.

Key points

- The main purpose with aggregated publication in the level 1 text was to ensure that the calibration of the transparency regime would work also for smaller non-equity markets where trading is dependent on market makers/SIs. ESMA's restrictive interpretation of art 11 MiFIR regarding aggregated publication is not in line with the political agreement between the co-legislators.

- A deferral regime only allowing Volume Omission (such as the American reporting system TRACE) is not sufficient for smaller government bond, mortgage bond and corporate bond markets where only a very limited number of end-investors and market makers are active. The transparency requirements would still expose market makers/SIs to undue risk which would have severe negative effects on their ability to provide liquidity to the market.

- Aggregated publication should be allowed as an alternative to Volume Omission. The added value with aggregated publication combined with an appropriate time delay is that investors can get sufficient information (e.g. for valuation and price formation) at the same time as market makers are protected from undue risk caused by transparency requirements. It is a way of balancing the needs of liquidity and transparency that is already in use in some Member States.

- The proposals by ESMA in Discussion Paper[1] to limit Competent Authorities powers to grant aggregation to "limited circumstances" and to certain types of non-equity instruments is not in line with the wording of level 1 and would in practice have the effect of turning aggregation into a useless calibration tool.

- ESMAs restrictive approach to the calibration of the transparency regime makes it difficult to create a single market for European financial instruments. If market making is no longer possible as a result of undue risk, many smaller non-equity markets will be drained of liquidity and close down. It will hamper the funding of SMEs and long term projects. It will limit the access to capital markets and increases the costs for SMEs trading on the capital markets. It will also make these markets less attractive for investments from outside the EU. If the harmonised transparency regime does not work also for smaller non-equity markets dependent on market makers/SIs, it will be very difficult to achieve the Commissions' vision of creating a Capital Markets Union.

The importance of calibrating post trade transparency requirements, in particular for small non-equity markets

Many existing non-equity markets in EU are too small to support order driven trading. Therefore, the markets have been organized as quote driven markets where the liquidity is provided by market makers/Sis, executing client orders by trading on own account. The existence of market makers ensures that investors are able to get out of also very large positions quickly - even if there are no end-buyers present in the market. When performing this service to its clients, the market maker takes on huge risk on its own books (e.g. market risk, credit risk) which it must be able to neutralize without being forced to immediately expose its positions to the public. If a market maker must show its positions in real time to its competitors, the market would move moves against it and lead to undue risk (e.g. Winners Curse).

It should be noted that on smaller non-equity markets (e.g. limited numbers of professional investors and market makers, low trading frequency and/or small currency area) market makers/SIs are typically more sensitive to immediate post trade transparency than in larger markers. One reason for this is that in a small market it is even more challenging for the market maker to find a buyer to the instruments which it has bought on own account in its capacity as market maker. Therefore, the market maker will be exposed to risk for a longer period of time during which it will need to hedge or otherwise unwind. Moreover, it should be noted that in a smaller non-

[1] ESMA 2014/548

equity market, the "information value" of a transaction is typically higher than in a larger market since the limited number of market participants makes it easier for competitors to figure out "who sits on which position" and be able to act on that information by taking contrary positions and thereby making hedging more difficult and the market making more risky.

If a market maker/SI is forced to publish details about a transactions without being given sufficient time to hedge or otherwise unwind its positions, it will be exposed to undue risk. This will negatively impact the market makers ability to provide liquidity to the market; affecting quoted volume and price. Some market makers/SIs would probably withdraw from the market altogether. The decrease in the liquidity that follows would have very negative effects for both investors and issuers that are active on the market.[2] It would become more difficult for governments to manage national debt and for SME:s[3] to attract financing, which in turn could affect the real economy and future growth in those Member States. It is crucial that the EU-wide transparency regime permit market makers also in smaller markets to hedge and unwind risk so that these adverse effects can be avoided.

Aggregated publication creates a balance between transparency and liquidity

Different calibration tools can be suitable for different markets/instruments. It is therefore important not to restrict the flexibility set forth on level 1 and to allow Competent Authorities to consider which method of deferral (or combination thereof) is more appropriate, taking the interests of investors, issuers and market structure into account (recital 16 MiFIR).

Aggregated publication was not in the Commission's original proposal but was included both in the European Parliament's final report and in the Council's compromise text. The main purpose was to introduce an additional calibration tool which was already evidenced to work well for some smaller non-equity markets (e.g. Sweden).

It should be noted that the calibration tool "volume omission" does not provide enough protection for market makers/SIs in smaller markets. The main reason for this is the very limited number of market participants and low transaction frequency; even if volume is omitted the other market participants will (based on the other information that is made public) still be able to figure out who sits on which position hence exposing the market maker to undue risk. Thus, even if volume omission works as a calibration tool for larger

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[2] Investors will be more reluctant to buy the instruments if they do not feel confident that they can sell them quickly and at low cost, i.e. instruments will become more risky. Investors will demand to be compensated for this increased risk, i.e. by higher interests. As a consequence, issuers borrowing costs will increase.

[3] The primary market is dependent on the liquidity of secondary market.

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markets, such as within the American reporting system TRACE, it would be very wrong to assume that it would have the same effect on smaller markets in the EU.[4]

Another way of calibrating the harmonised transparency regime so that it does not harm the well-functioning of smaller non-equity markets would be for Competent Authorities to allow extended time deferrals during which all information is omitted (price and volume). However, considering that in some illiquid markets it can take weeks or months to find an opposite interest, such extended time deferrals would need to be very long in order to have the desired effect and the value that investors would have of the information would then probably be limited.[5]

Aggregated publication in combination with a shorter time deferral is however a useful calibration method for smaller non-equity markets dependent on market making. It allows the investors to get information in a timely manner whilst market makers/SIs are still able to efficiently neutralize their risks. Aggregation can therefore be said to properly balance the needs of transparency and liquidity.

How does aggregated publication work in practice – Sweden a case in point

Aggregated publication of post trade information has already proved to be a calibration technique that works well for some smaller non-equity markets. In Sweden[6], aggregated publication of post trade information is used for transactions in government bonds, mortgage bonds, covered bonds and derivatives linked to these instruments, which are listed at a regulated market or MTF.

According to Swedish law and regulation[7], market makers shall report to the Swedish Stock Exchange[8] on an aggregated level at the end of each business day. The following information is reported: high, low and average yield during the day and aggregated volume. At 09.00 am the next day (EOD+1), the Stock Exchange publishes the information on its web-page. As the information is reported at aggregated level with a relatively short delay, it provides the professional investors which are active on the market with timely infor-

[4] In its reply to ESMA's Discussion Paper also the Swedish National Debt Office notes that volume omission is insufficient for smaller markets.

[5] For very illiquid instruments e.g. that do not trade every day, extended deferral times (up to T+10) could however be necessary. Where instruments do not trade several times of day, aggregated publication does not work.

[6] Characteristics of the Swedish government bond market: There are 6-7 market makers which are under an agreement with the Swedish National Debt Office to participate in auctions on the primary market and to provide quotes to end-investors on the secondary market. In principle only wholesale investors are active on the secondary market and approx. 20 percent of the investors stand for 80 percent of the trading. A normal size transaction is approx. 100-200 mSEK. Important is also that Sweden has its own currency (SEK).

[7] Chapter 7 para 3 FFFS 2007:17.

[8] NASDAQ

mation which can be used e.g. for valuation and best execution purposes.[9]

It should be noted that the Swedish Investment Fund Association in its reply to the ESMA consultation has expressed that aggregated publication works very well from an asset management perspective. Also both Swedish National Debt Office and the Danish National Debt expressed in their replies to ESMA that aggregation is a suitable calibration method to protect market makers/SIs from undue risk, in particular for smaller markets. The Swedish Supervisory Authority has also in many different contexts expressed the view that the system with aggregated post trade publication for government bonds and mortgage bonds work adequately. There is no reason why aggregated publication should work just as well for other small non-equity markets where all trading is dependent on market makers/SIs– within or outside the euro area.

ESMA's proposals are not in line with political agreement/level 1

In its Discussion Paper, ESMA asked stakeholders only two questions regarding aggregation (Q 148 and Q 149). This is unfortunate, in particular since the analysis in the Discussion Paper seems to indicate that there are some misunderstandings as to how this calibration tool works in practice and which purpose it serves in the context of MiFID 2. In our opinion, ESMA's interpretation of aggregated publication is not in line with the political agreement decided between the co-legislators on level 1.

Below is a summary of our main concerns in respect of the Discussion Paper:

- ESMA proposes that aggregation should only be available in ”limited circumstances”. There is no support for such restrictive interpretation of the level 1 text and this is not in line with the political agreement between co-legislators. If the use of aggregated publication was to be limited in the way ESMA proposes it would be absolutely useless and not serve its purpose of protecting the well-functioning of smaller markets by allowing market makers the possibility to hedge/unwind risk.

- According to level 1 there is no restriction as to the types (classes) of instruments for which aggregated publication could be available. Aggregation should be available for sovereign debt as well as for other bonds (mortgage bonds/covered bonds and/or corporate bonds) and derivatives.

[9] The professional investors active in this market also have access to indicative pre-trade prices which helps the price formation process.

- ESMA seems to take the view that aggregated publication should not be available for instruments for which there is no liquid market. However, many instruments which in the eyes of MiFIR will fall into the ”illiquid instrument- box” trade more often than once a day and for those instruments aggregation could be an option.
- ESMA’s interpretation of ”extended time period” and ”indefinite” does not seem to be in line with the level 1 text nor the intentions behind the political agreement. To our understanding, the reason why the text included a possibility for ”extended period of time”, was that some Member States took the view that publication of individual details could be to the detriment of market makers even for other instruments than sovereign debt.[10] From a linguistic perspective we also find it difficult to accept the statement by ESMA that “indefinite” should not be “indefinite”.
- As a final general remark, considering that the level 1 text lacks a clear step-by-step introduction of the new transparency regime for non-equity instruments, it is important to keep a flexible regime on level 2, enabling Competent Authorities to take the interests of investors, issuers and market structure into account (recital 16 MiFIR).

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[10] One example: Sweden is a small currency area with only limited number of instruments available for hedging. Therefore, mortgage bonds are often used to hedge positions in government bonds (and vice versa). In order for this market to work well after implementation of MiFID 2, it is important that the trading in both types of bonds can continue to take place under similar conditions. Therefore, assuming that the Competent Authority will allow market makers to publish information on transactions in sovereign bonds at aggregated level EOD +1, the same should be able to apply for the mortgare bonds used for hedging – albeit the publication of individual details in the latter transaction could only be postponed using the possibility for ”extended period” in art 11.3 c MiFIR (as ”indefinite” only applies for sovereign bonds).