

# MiFID II – redesigning Europe's markets

The clock is ticking, the suspense is high: Very soon, the biggest market reform in decades kicks off. The Markets in Financial Instruments Regulation (MiFIR) and Directive II (short: MiFID II) will fundamentally redesign Europe's derivatives markets.

As a global derivatives exchange and the largest venue in Europe, Eurex will play a key role in this significant undertaking, adding crucial value to the mammoth project. But how can an exchange reduce the stress in the markets by assisting in a smooth transition to the new regulatory structure? Well, let us first look at the main components of a well-functioning derivatives market.

**Transparency.** Providing transparency is one of the most important roles of any exchange. There are various aspects to this, be it the organization of order book trading, pre- and post-trade transparency or the communication to regulators and the market.

**Liquidity.** One of the most essential roles of a derivatives exchange is to standardize financial instruments with common contract specifications. As an exchange, we are leading the way in enabling instruments to transition from Over The Counter (OTC) trading to an efficiently organized environment. As a result, trading interests are transparent and pooled – and accessible to heterogeneous market participants.

In particular, risk transfer markets rely on the liquidity found in exchange traded futures or options. In critical market situations, liquidity in bilaterally-traded products does not allow for efficient risk management. This is precisely the time when market participants turn to liquid markets in legally certain environments – what is known as the “flight to quality”.

**Resilience.** This concept captures various aspects: market, operational and system resilience. Market resilience measures the volume size an order book absorbs and how fast it recovers from stress. Risk management via central clearing is an integral and key feature of exchange traded derivatives. The other aspects address operational functionalities, risk controls and system safeguards that allow for orderly trading.

## A look at key factors

How do MiFID II and MiFIR have a bearing on these key functions?

Again, let us look at transparency: MiFIR extends the transparency mandate from equities to non-equities, including bonds, derivatives and emission allowances. The regulator defines the levels for transparency in pre- and post-trading for market participants and trading venues alike. There are also specific publication and reporting rules. These complement the efforts under other legislation (Market Abuse Regulation – MAR – and European Market Infrastructure Regulation – EMIR)<sup>1</sup>.

Increasing transparency is the sure path to sound and stable markets. However, some commentators have expressed caution about the broad approach regulators have taken to the huge task of defining liquidity and transparency classes. In the past, exchanges had the expertise to assess liquidity for their local order books. They were able to fine-tune thresholds together with market participants to set block sizes or publication rules.

<sup>1</sup> EMIR looks at reporting from a risk perspective; MAR sets the basis for reference data and standards for surveillance purposes.

Complexity does not end here. Brexit will be a game-changer. Much of the work on MiFID II has been done with London as the largest financial centre and as part of the European Union. As this will change radically, there is certainly a need to review and recalibrate the rules that are about to be implemented on 3 January 2018.

It's also important to ask how MiFID II will affect liquidity. Clearly, liquidity is a very sensitive topic. Unintended consequences or contradicting rules can substantially affect markets. It is crucial to maintain liquid products with deep order books and to support markets with liquidity providers where required. Otherwise, risk transfer is impaired.

This is ambitious for one market and very difficult across a number of markets. The ecosystem of derivatives markets depends on many levers. Wrongly calibrating one of them will not impact only one market, but all markets. It is therefore paramount to allow for diversity of trading motivation and therefore, of market participants.

### **Resilience is crucial**

Last, but not least, how will resilience develop? MiFID II addresses orderly trading broadly. The regulator took special care to address the increased degree of automation in markets and to mandate trading venues, Central Counterparties (CCP) and market participants alike to precaution. Trading venues are requested to have meaningful safeguards in place – on functional and systemic level, which are mirrored for market participants.

Among the requirements for trading venues, it is mandatory to have risk controls in place and to look closely at system capacities. There are also various specific rules for algorithmic and automated trading, specifically under the chapter of microstructural issues. EMIR broadly regulates CCPs. However, MiFIR extends some of the aspects for derivatives markets and demands broad straight-through processing rules and further post trade aspects, such as indirect clearing.

### **Response to upcoming changes**

Eurex is responding to all these significant changes on the horizon.

To foster greater transparency, we carefully calibrated the threshold levels foreseen in MiFID II. We will keep them as harmonized as possible, in order to support market participants to keep an overview of products and the related

thresholds. Where our block sizes are already above the levels currently proposed by the European Securities Markets Authority, we will continue to adhere to these higher transparency levels. Furthermore, trade reporting will be timely, and reporting based on non-disclosure limits will be pursued, where sensible for the market.

For pre- and post-trade levels, Eurex will monitor for changes of the nature of the order book after January 2018. We will liaise with market participants and other exchanges to identify positive and negative aspects and report to regulators if unintended consequences become apparent or if the objective of transparent markets risks being compromised.

Transaction reporting requirements have changed and trading venues need to report for third country firms. Eurex, together with Deutsche Börse's Regulatory Reporting services, will address this new requirement. Also under MiFIR, trading venues must provide the audit trail to competent authorities. This requires market participants to report additional information to the exchange. For sensitive information, Eurex will offer a short code solution, to increase certainty for trading participants that information will be adequately ring-fenced and available in not one but in several separate systems.

### **Eurex enhances its market structure**

In light of the changes ahead, we will continue our track record of innovation, thus helping market participants to cope with the regulatory changes. We enhance our market structure by launching an electronic price discovery platform that allows bank's broker desks and inter-dealer brokers to contact market makers with requests for quotes in order to find a counterpart to a trading interest in large sizes or complex strategies.

Also, to further address our strength in product standardization and to act as innovator, Eurex directly contributes to the regulatory agenda by working with market participants to shift OTC business onto regulated trading and clearing venues. As showcase for such innovation on the border between listed and OTC products, we have developed a listed solution for implied equity repo trading via EURO STOXX 50® Index Total Return Futures (TRF).

The new futures complement our suite of equity index derivatives and support the market in complying with new financial market legislation like the Capital Requirements Regulation. Also, they add to operational efficiency. Eurex Total Return Futures offer returns analogous to Equity Index Total Return Swaps, representing a functional replacement for these OTC instruments.

Eurex so far not only managed to introduce the product on the exchange environment, alongside central clearing, but the market in this instrument developed favorably and liquidity increased significantly since December 2016. In 2016, the total return swaps market in EURO STOXX was 100 billion Euro. Notional value traded year to date was 13 billion Euro, migrating more than 10 percent of which was previously traded OTC up to a year ago to Eurex.

### **A complex undertaking**

Eurex designed its market making requirements according to the regulatory mandate and will offer agreements to the respective firms, as well as schemes for the scope of products elaborated in the law. We are intending to improve market quality during periods of volatility by introducing significant incentives, especially for options. We have worked together with the market participants on the design of these additional incentives.

While this is already a complex undertaking, the authorization requirements for firms dealing on their own account are also crucial and could affect market liquidity, if not managed properly in uncertain times. These firms are often liquidity providers, and they are confronted with diverging rules. On the one hand, such firms are required to provide quotes continuously in the order book, while on the other hand, unproportioned prudential regimes have been discussed that could be applicable to these firms in the future. This would hinder their ability to satisfy the previous requirement.

Striking the right balance in growing financial markets, as foreseen under the planned Capital Markets Union, and calibrating a proportionate prudential regime, as discussed under the Capital Requirements Regulation in order to have liquid markets, as pursued under MiFID, is a Gordian knot. It needs to be solved by legislators and regulators together with the market. This is important if we are to avoid important market makers being crowded out. It's also important to bear in mind that a healthy ecosystem requires a heterogeneity of participants.

Moreover, alongside this objective to allow for a healthy mix of market participants in a global setting, Eurex will continue to closely engage in regulatory discussions to increase legal certainty for firms that require authorization or exemptions under MiFIR.

For third country firms, encouraging proposals have been seen in the current transposition of MiFIR/MiFID II into the German legal framework. It is suggested to have a form of transition period and exemption regime for third country firms, especially when dealing on own account.

### **Resilience is key**

To enhance resilience, Eurex has already introduced most of the risk controls and system safeguards recommended by MiFIR/MiFID II. Such functionalities can for example be: volatility interruptions, pre-trade or post-trade risk controls and limits, market maker protection, stop buttons /kill switches, or system safeguards such as throttling measures and fuse boxes.

Currently, Eurex' customers have the possibility of getting to grips with new technical world in our simulation environment which will be available until 4 December 2017, when the new Eurex T7 Release 6.0 will be introduced, widely implementing all kinds of MiFIR /MiFID II requirements. So far, beginning in November this year, market participants representing almost 70 percent of the traded market share have actively participated in these simulations. From 4 December onwards, market participants will also be able to practice the new world in a production environment, to ensure readiness for 3 January 2018.

Eurex will closely monitor developments in the markets and keep tabs on unintended consequences. We will be involved in discussions to improve markets, and stay in close contact with our clients and regulators to ensure a smooth transition into the new market structure designed under MiFIR/MiFID II.

If you have any questions or comments please do not hesitate to contact [customer.readiness@eurexchange.com](mailto:customer.readiness@eurexchange.com)

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