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ECMI Policy Brief

New market conduct rules for financial intermediaries: Will complexity bring transparency?

by Karel Lannoo

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The financial crisis led to a raft of new or updated EU conduct rules to ensure the orderly functioning of markets and market operators. These matters only arose as the financial crisis gained momentum, uncovering market practices that should have been tackled much earlier.

Generally speaking, the new conduct rules deal with soft rules on the behaviour of market participants and hard rules prohibiting distortive practices. New EU-wide rules were agreed on short selling and the formation of financial benchmarks, and there was a substantial upgrade of existing rules on market manipulation and the behaviour and governance of securities markets participants. Overall, rules have become more complex and very detailed, following the single-rulebook approach, rather than the principles-based light touch that prevailed in the past. The degree of detail is such that it has become hard to make a general assessment of the new rules and of their impact. Much will therefore depend on their proper implementation, which is a huge challenge for both markets and supervisors.

The core of the new regulatory framework is contained in the Market in Financial Instruments Directive and Regulation (MiFID II), a massive upgrade of its 2004 predecessor, in both depth and breadth. MiFID II organises securities markets and sets the rules governing market participants. The main novelties compared to the 2004 text are the addition of a trading facility; the Organised Trading Facilities (OTFs); the rules on algorithmic trading; the licensing of data publication arrangements and the regulation of trading in bond and commodity markets. In addition, MiFID II, in combination with EMIR (European Market Infrastructure Regulation), sets the framework for the trading of sufficiently liquid standardised OTC derivatives, further to the Pittsburgh G-20 conclusions.

Early on in the sovereign crisis, policymakers had to react rapidly with new rules on short selling and speculation on credit default swaps to address their effects on government debt markets. There was concern that speculators were driving up spreads in secondary markets for government debt, ultimately without owning the underlying securities. It appeared that there was no EU-wide definition for such uncovered positions, which required a rapid remedy, but provoked criticism among market participants.

Separately, the 2003 rules against market manipulation and insider trading were strengthened, taking the lessons of the crisis into account. The directive became a regulation to ensure consistent application across countries; a parallel directive requires member states to adopt

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administrative and potentially criminal sanctions to ensure the effectiveness of the policy on market integrity (MAD-MAR).

The apparent lack of rules on the formation of financial benchmarks was highly publicised, following revelations in July 2012 about the manipulation of the Libor and Euribor rates. This led to an EU regulation on the formation and governance of benchmarks, the last in the series of post-crisis measures. But it also gave rise to a number of multi-million fines to banks on both sides of the Atlantic and dealt a further blow to the reputation of the banking sector after the financial and sovereign crisis.

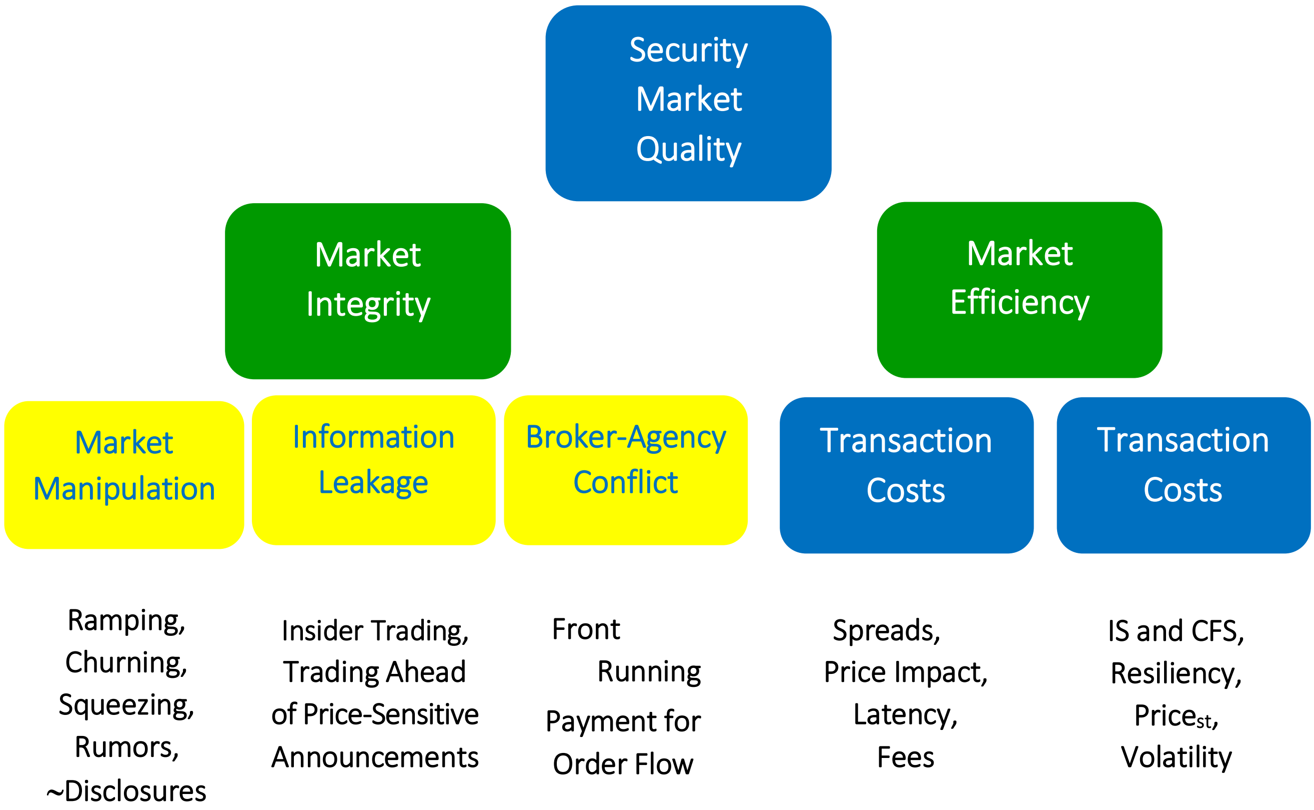
Overall, these regulatory actions highlight the absence of any central supervisory authority with broad discretionary powers. As gaps appeared in the regulatory framework, the EU had to resort to the complex route of regulatory updates via the usual procedures to ensure consistent application in the single market. A central authority could have enacted rules more rapidly as part of its discretionary powers, as is the case for banks in the eurozone under the single supervisory mechanism.

This paper considers the novelties of the market conduct rules that were enacted during and after the financial crisis. We will start with a discussion on measuring and maintaining market integrity, followed by the key regulatory measures; firstly, the principal changes brought about by MiFID II; then the more detailed rules tackling short selling, market abuse and the formation of benchmarks. The rules were complex even before the crisis; post-crisis there was an expansion to thousands of pages, whose implementation is, at the time of writing, still under way. The challenge is thus to capture the whole picture.

1. Measuring and maintaining European market integrity

Unlike financial stability, the art of assessing financial market quality is much less developed. There is no commonly accepted agreement on how to order the principles governing the policy framework. Changes mostly happen in reaction to events, such as the uncovered short selling, the flash crash or the Libor manipulation. Up until the crisis, EU security market rules such as MiFID had mostly focused on market efficiency and on opening up competition among securities markets in the EU, with rather less focus on integrity. The financial crisis set the pendulum swinging and new rules or amendments focused more on market integrity. As the EU is trying to build a capital markets union, a broader discussion on the principles underlying capital market regulation, and on the proper calibration of financial market quality, is required. Aitken (et al., 2014) propose a market quality framework in which five key metrics of market design are related to the two main elements, market integrity and market quality. The measure discussed below, adopted in the wake of the financial crisis, focused on the former.

Figure 1. Ordering securities market quality



Source: Aitkin, et al. (2014).

The price transparency in bond markets, in the context of MiFID II, is a case in point. This subject has been on the table since the days of MiFID I, but more than 10 years on it is still unresolved, judging from the debate surrounding the MIFID II implementing measures for bonds. Market participants consider the efficiency of markets to be primordial, as more transparency would undermine liquidity, but the integrity of the market – ensuring the market is fair for all – seems to be less of a concern. In the aftermath of the crisis, it would be useful if regulators could decide this issue, and act accordingly. Either they state that market efficiency precedes integrity, or they also enhance market integrity, and develop the necessary toolkit (Aitkin, 2015; Austin, 2015). This would certainly enhance market confidence for retail investors in the EU, who are much less exposed to markets than their US counterparts. Indeed, European households are overexposed to bank deposits and invest much less in funds and stocks than US citizens (Lannoo, 2015).

IOSCO, the international organisation of securities markets supervisors, identifies the key objective of securities regulation as "protecting investors" and "ensuring that markets are fair, efficient and transparent" (IOSCO, 2010). As far as we are aware, the European Commission has not established a clear ordering of objectives in its CMU Action Plan, which could have facilitated the setting of regulatory priorities.

Some EU member states have gone further and set clear objectives. The UK's Financial Conduct Authority (FCA) puts market integrity on the same level as promoting competition. It even developed a Market Cleanliness Statistic to measure the performance of its activities, focusing on efficiency as much as on fairness of markets. The statistic seeks to detect suspicious movements in equity prices shortly before important corporate announcements, such as takeovers. The FCA finds that the level of such suspicious activity has declined since 2009 (based on data gathered from 2002 onwards), around the time that the former FSA began to emphasise its credible deterrence strategy, possibly highlighting the impact of its actions (FCA, 2014). The same methodology was used by the Australian securities market regulator, which also found an improvement in the local market (ASIC, 2016). Generalising such assessments in EU markets might be useful, but on 9 July 2014 the ESMA board decided not to pursue work on cleanliness indicators at EU level.

2. Managing MiFID II

Coming so soon after the start of MiFID I, the review of the directive is a recognition that MiFID I leaned too much towards market efficiency, but not sufficiently towards integrity. MiFID II tries to redress the balance and takes lessons from the crisis, but at a heavy price for market operators. MiFID I brought increased competition to trading venues, but at the cost of transparency. MiFID II introduces a radical upgrade by improving price discovery through extending pre- and post-trade transparency to non-equity products, detailing the waivers of these requirements, instituting a centralised system for data consolidation and tightening the operational and governance requirements for market intermediaries. MiFID II also strengthens investor protection by further detailing the conflict of interest provisions. But its implementation will take time to materialise.

As with other new post-crisis measures, MiFID II is split into a regulation and a directive, with the regulation covering the price transparency rules. The new measure was proposed in November 2011 and adopted in April 2014, but its implementation will only take effect in early 2018, also because MiFID II comes with a raft of secondary legislation. Whereas MiFID I was complemented by two pieces of secondary legislation, a regulation and a directive, this compares so far to 37 (!) Regulatory and Implementing Technical Standards (RTS and ITS) and delegated Commission regulations and directives in the case of MiFID II, with a few more ITS still to come. MiFID I was drafted in the aftermath of the Lamfalussy Committee recommendations. Its successor takes this forward under the new supervisory authorities' single rulebook structure and multiplies the regulatory requirements exponentially. As with MiFID I, the EU Commission justifies the upgrade with the argument of creating a level playing field and market efficiency, but also by citing the lack of price and cost transparency in securities and derivatives markets for users and supervisors, and insufficient investor protection, which was highlighted in the miss-selling scandals (European Commission, 2011). The end-result is a wholesale departure from the light touch principles-based approach that prevailed in the past to a heavy-handed rules-based regulation.

ECMI research recognised that the lessons of the crisis and the need for more safety would lead to more prescriptive regulation, but called for regulatory intervention to be proportional to the nature of each segment of the securities and derivatives markets (Valiante, 2011).

Another paper on the implementation of MiFID I found that, while the new rules had a positive effect on efficiency and competition in financial markets, there was a lack of enforcement and fragmentation in national implementation (Assi and Valiente, 2011). The latter paper, based on a survey of market participants and regulators, detected problems in data quality, in pre- and post-trade price transparency, and in the enforcement of the conflict of interest provisions. Similar conclusions were reached in a report for the French Finance Ministry, which stated that, while competition between trading platforms had increased as a result of MiFID, the end investor had not necessarily experienced a decline in prices (Fleuriot, 2010). The transparency of and the access to the post-trade data decreased as a result of the fragmentation of order flow. Data transparency should therefore be organised, the report concluded, and a central authority be given greater powers to ensure consistent enforcement and the capacity to react to changing market circumstances.

More recently, an ESMA 2015 report found that the level of implementation of the MiFID best execution provisions, as well as the level of convergence in the general supervisory practices by NCAs, was low. In particular, 15 NCAs were found not to apply or only partially apply criteria considered essential for ensuring an effective best execution under MiFID. A follow-up peer review in September 2016 already brought about considerable improvements (ESMA, 2016), although this was ten years after the implementation deadline of MiFID.

2.1 The MiFID II structure

As regards investment firms and regulated markets, MiFID II follows the structure of MiFID I, but has grown considerably in length and scope. It sets procedures for the authorisation of investment firms and regulated markets and their operating conditions. The conduct of business rules for investment firms have been greatly extended, with much more detailed provisions in the directive regarding investor protection and new provisions regarding high-frequency trading (HFT) and Organised Trading Facilities (OTFs). Often, provisions that were level 2 before have become level 1 in MiFID II, whereas level 2 becomes more technical, and sometimes less substantial. A new section has been added on data reporting providers, covering Approved Publication Arrangements (APAs), Consolidated Tape providers (CTPs) and Approved Reporting Mechanism (ARMs). The regulation MiFIR covers the pre- and post-trade transparency rules and the waivers to these provisions, an issue that gave rise to lengthy discussions. It covers equity, non-equity products and derivatives.

The big difference to MiFID I is the extensive level 2 legislation, on which most measures were formally published by mid-2016. An overview of the different RTS, ITS and their length is given in Table 1, see Appendix. Compared with the 2004 MiFID I, this is an increase in length of the entire legislative package, measured by word count, by a factor of about five, continuing a trend set by MiFID I when it replaced the much shorter Investment Services Directive of 1992. In 2006, when MiFID I was finalised, we criticised the excessive detail of the new directive (Casey and Lannoo, 2006). Ten years on, the tendency towards minute detail and rules-based regulation has continued.

To some extent, the growth in markets regulation is related to the broader scope of MiFID II. This now includes, as indicated above, the regulation of data providers, price transparency in non-equity and derivative markets and high frequency trading. Furthermore, certain aspects of MiFID I did not function well, such as the conflict of interest or best execution provisions, which necessitated more detailed rules. The argument of a level playing field, already used when MiFID I was finalised, continues to be used to justify the regulatory build-up, but is now called a 'single rulebook'. Businesses may also prefer more prescription to regulatory uncertainty. Hence, if this process contributes to regulatory quality and an effectively functioning single market, there should be no reason for concern. If, however, further harmonisation does not allow for more integration, the process should be questioned.

We will try to review this question through a detailed look at the core elements of the new regulatory regime. We start with the upgraded elements of MiFID I and move on to the new elements of MiFID II.

Best execution

The requirement to execute orders on terms most favourable to the client is core to market regulation. The central rule of MiFID I, which was new at the time, is maintained, and what was level 2 before has now become part of the level 1 directive in MiFID II. Best execution is based on a broad set of criteria, but for retail clients the best possible result is the price of the financial instrument and the costs relating to execution, which will include all expenses (Art. 27). Firms need to establish order execution policies whose effectiveness should be assessed on a regular basis, but conflicts of interest or inducements in routing client orders to certain venues are prohibited. Firms will need to publish data on execution quality, at least on an annual basis, including details about price, costs, speed and the likelihood of execution (see RTS 28). The rules on the handling of client orders and obligations when working through tied agents have been maintained (Art. 28-29).

Investment advice

With its provisions on investment advice, the EU aims to take a firmer line on conflicts of interest, inducements and cross-selling practices in the financial sector. Although we might say that the rules were embryonic in the 2004 directive, they have been spelled out more clearly, brought into level 1, and substantially upgraded and broadened in MiFID II. The key novelty is the requirement for investment firms to inform clients about whether or not investment advice is provided on an independent basis, i.e. paid by the user, and the ban on all payments from third parties, apart from certain "minor non-monetary benefits", "capable of enhancing the quality of service" (Art. 24), if advice is included. This should ensure that clients are not sold inappropriate products, and that inducements are only allowed if they benefit the client.

The provisions on investment advice are largely based on the UK's retail distribution review (RDR), which came into effect at the end of 2012. It was designed to restore trust in financial advice after the financial crisis and applies to advisers, banks and other providers of financial products. In an EU context, this opens a Pandora's Box, however, as it concerns services and products that are covered by a diversity of providers, firms or intermediaries, for a very diverse market with diverse practices, following different pieces of regulation and often with different supervisors in charge. Furthermore, it raises the issue of how investment research is segregated from advice.

To ensure some consistency across sectors, the MiFID II investor protection rules also apply provisionally to insurance products, awaiting the entry into force of the updated Insurance Distribution Directive (IDD). The IDD introduces similar investor protection provisions (best execution and conflict of interest) to MiFID, and will come into force in 2018. But firms can still be organised as UCITS management companies (UCITS IV) or under the Alternative Investment Managers Directive (AIFMD). The PRIIPS regulation (packaged retail and insurance-based investment products), which applies gradually from 2017, attempts to correct information inconsistencies and applies to investment products horizontally, but only covers in the key investor information the disclosure of fees, not the level.

The rules on inducements are further detailed in a Delegated Directive (DD1). It states, among others, that firms can pay for research only from their own resources, or need to create a research payment account, which can only be funded through a research charge to clients. The total amount of research charged to clients cannot exceed the budget of the research payment account. Additional disclosures about research have to be made to clients. Unbundling payments for research from payments for transactions should shift the focus from the number of transactions to the actual quality of the research and ensure that revenue from client portfolios are not used to gain access to research for free. This is seen to be very problematic to implement for large banks that were funding investment research through their client portfolios. But better implementation of the rules on inducements will also reduce the flow of profits many retail banks make through retrocession fees for their successful distribution of third party funds. Implementation of the new rules is seen to be very problematic, and may actually prove to be counterproductive. The impact of the retail distribution review in the UK is not seen to have been successful so far, as investors seem to prefer bundled rather than unbundled prices.

A licence for market data providers

MiFID II introduces a licence for and supervision of market data aggregators. The problem with verifying whether best execution was effectively applied was that there were no single or standardised data feeds to check whether the trade was effectively executed on the best terms for the client. Firms could internalise trades or execute them on a variety of trading platforms.

The issue of data feeds was already discussed in the context of MiFID I, but it was assumed, incorrectly, that markets would come up with a solution.

MiFID II distinguishes three different forms of data providers: Automated Publications Arrangements (APAs) for systemic internalisers, this is internal own account trading activities of investment banks; Consolidated Tape Providers (CTPs) for those who collect and consolidate data from APAs and trading platforms; and Approved Reporting Mechanisms (ARMs) for regulatory information. These three different forms require authorisation and ongoing supervision by the national competent authority and notification to ESMA. They are required to have the management and organisational arrangements in place to offer such services.

By institutionalising data vending arrangements, the EU is following the lead taken by the UK in this domain in 2007. The latter had required data providers to register as Trade Data Monitors (TDMs) in the context of the implementation of MiFID I, which was then seen to be a form of goldplating, an additional requirement to the MiFID rules. At the time, the UK argued that the growth of off-exchange trading would increase the probability of data fragmentation, which would reduce market transparency, hinder price discovery and undermine equity market efficiency (see Lannoo, 2007). This is in effect what MiFID II now tries to correct.

Implementing the new regime still raises a host of issues. Why was ESMA not chosen as the competent authority for data providers? ESMA already supervises trade repositories and rating agencies, and thus has already built up expertise. In addition, the data vending business is very concentrated, with two dominant players, which makes centralised supervision more efficient. As supervision of data providers is new for almost all EU countries, it would have been preferable to build on the existing expertise at ESMA rather than requiring member states to build up capacity in local supervisory authorities. Data services are the subject of an RTS, which basically addresses governance and business continuity issues, much the same way as they are for regulated markets (RTS12).

Trading venues

MiFID II adds Organised Trading Facilities (OTFs) as trading venues alongside regulated markets and Multilateral Trading Facilities (MTFs), and expands the facilities for Systemic Internalisers to also trade non-equity products. MTFs were a creation of MiFID I and have been widely taken up as the regime for alternative trading platforms, as competition to the main regulated markets, such as BATS and Turquoise, but also for the secondary markets of the traditional exchanges, such as AIM, Alternext or MAB. OTFs are defined as a multilateral system that is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives interact (but not equity). OTFs were created further to the G-20 commitment to bring all standardised OTC derivative contracts on exchange and are the equivalent of the US swap execution facility (SEF) of the Dodd Frank Bill. OTFs can execute orders on a discretionary basis, which the other venues cannot. They were created to tackle further fragmentation of order flow, reduce dark pools and bring certain activities of broker crossing networks or systematic internalisers into the open.

What appetite there will be for the OTF facility remains to be seen, but the EU rule will only come into force in 2018, about four years later than the comparable US rule, which had limited take-up in the US (see the number of registrations with the CFTC). In addition, there has been the overall decline in trading volumes within banks following tighter prudential standards, but also as a result of risk averseness of investors in a post-crisis context. At the time of discussions on MiFID II, it was argued that there was no need to create a special facility, because the MTF regime could cater for these needs (Valiante, 2012).

MiFID II also tackles waivers to pre-trade transparency for block trades and algorithmic trading. The share of 'dark pools' of liquidity or non-displayed liquidity increased with MiFID I, reducing the price discovery process of regulated markets and MTFs. New rules reduce the possibility for such 'dark pools', a sensitive subject in a post-crisis context, through a reduction of the waivers from 'lit' trading in MiFID I, and the price reporting requirements for Systemic Internalisers. 'Double Volume Caps' aim to limit trading in non-displayed liquidity (i.e. dark pools) by introducing a cap on the use of two transparency waivers. The delay in implementation of the new rules, however, means that the current trends of dark pool trading have persisted for some time. The new rules on algorithmic or high-frequency trading require firms to have adequate systems in place to manage such trading and prevent market disruptions.

Price transparency for non-equity markets

Another controversial issue in MiFID II is the price transparency of non-equity markets, comprising bonds, derivatives and structured products. Before MiFID II, there was no obligation for intermediaries to publish pre- and post-trade prices in non-equity markets. This issue was already discussed in the context of the original MiFID, but never really acted upon (see consultations by EU Commission in 2006 and CESR in 2007). As far as bond markets are concerned, the issue arose from an investor protection perspective, as no data feed existed to check whether best execution was applied for trades that were largely conducted bilaterally. For derivatives markets, the issue emerged following the financial crisis from a financial stability perspective, and further to the G-20 commitment to bring more transparency, and to require central clearing and trading of OTC derivatives.

For bond markets, the implementing rules rely on a very complicated system, taking the level of trading in a certain bond, and the size threshold (>€500m for bonds and >€1bn for government bonds) from which the price transparency rules will apply (see RTS2). They will be implemented gradually over a period of four years, depending on the results of annual liquidity testing. According to market participants, 90% of the volumes of bond traded will be covered from 2018 onwards, which however covers only 2% of the bonds outstanding (see ECMI, 2017). For derivative financial instruments, the rules require liquid derivatives that are centrally cleared, to be traded on a regulated trading venue following the price transparency rules. In both cases, when trades are executed by investment banks, pre-trade and post-trade data should be made available through an automated publication arrangement (APA).

A topical issue in the debate was the positions limits on commodity financial instruments. Unlimited positions were seen to distort or undermine certain markets, such as energy or agricultural commodity markets. Member states must apply position limits on the net position a firm can hold in commodity derivatives depending on the liquidity and size of market, and will require firms to report on a daily basis.

2.2 Impact: A MiFID II revolution?

The MiFID I rules led to a revolution in European securities markets. Competition between trading venues increased, new trading venues emerged and trading costs declined. Compared to 2007, the equity markets landscape changed dramatically, with a new entrant, BATS becoming the most important trading venue in the EU (see ECMI Statistical Package). MiFID I also strengthened investor protection, with rules on client suitability and appropriateness of investment advice, and tackling conflicts of interest and inducements. Improper implementation of the latter, combined with the lessons of the crisis, led to a profound update, above all on the market integrity side of the requirements.

MiFID II is initially a huge implementation and systems adaptation exercise, with the requirement to store enormous amounts of data to trace best execution in a broader set of market segments, to consolidate these data and report to supervisory authorities. Longer term, MiFID II will bring:

- a further change in the trading venues landscape, with OTFs and more scope for MTFs, and reduced attractiveness of the OTC markets. New trading platforms for bonds and derivatives can be expected to emerge further to the new price transparency requirements, and possibly a more direct participation of investors in the bond markets;
- structural changes in universal banks, and in the way banks fund research. The requirement to create research accounts will force banks to change the way they finance analysts. Fund managers will need to set up their own research divisions, or pay for customised information from independent outfits.

The backdrop to a long implementation phase is that, at least for the G-20 related elements of the changes, the EU has a long delay compared to the US, which is already considering to change its rules again. The rules on on-exchange trading of standardised OTC derivatives came into force in the US in October 2013, but in Europe it will only be in 2018.

3. Market abuse

The new market abuse rules extend the scope of the 2003 directive, including alternative trading facilities and other financial instruments, and strengthen the capacity of supervisors to ensure minimum sanctions for market abuse. The former is covered in a regulation (MAR), the latter in a directive (MAD). For the EU, the update of these rules is needed to strengthen market integrity, as the financial crisis highlighted many cases of manipulation that could not be adequately covered under the previous rules.

The first EU-wide rules on insider trading date back to 1989, when many EU countries, including Germany, did not yet have any rules at national level. The insider dealing directive of 1989 coordinated the rules governing treatment of this activity, made it a statutory offence and required member states to create a supervisory body. Unlike the practice in the US, a charge of illegal trading is not based on breach of fiduciary trust, but on the possession of non-public information, or information which if it were to be made public, would have a significant impact on the stock price. Primary insiders are prohibited from either trading or tipping, and secondary insiders are prohibited from trading, but are not subject to anti-tipping provisions. The directive was updated in 2003, and renamed the Market Abuse Directive (MAD). It further harmonises EU rules, establishes a strong commitment to transparency and equal treatment of market participants, and strengthens cooperation among supervisors. Following the Lamfalussy approach, the directive was also subject to three implementing measures. Some 'hot' items in the 2003 debate were the inclusion of financial journalists as possible market manipulators (and the freedom of press), and the role of analysts, and their possible conflicts of interest.

The new MAD/MAR strengthens the provisions further. They were adopted in 2014 and came into force in mid-2016, together with 11 implementing measures (ITS and RTS).[1] The main elements of the new regime are:

- a tighter definition of insider information and insider dealing, who is considered insider and what are the restrictions on insiders. An insider is a person with managerial responsibility (PDMR) in a firm and those that are closely related to her/him. They cannot deal in an issuer's securities in a 'closed period';
- conduct of market soundings both by issuers and by persons acting on their behalf requires consideration of whether the sounding will involve the disclosure of inside information;
- an inclusion of all forms of market manipulation;
- a broadening of scope to include issuers of securities traded on multilateral trading facilities (MTFs) and organised trading facilities (OTFs). The 2003 directive was only applicable to issuers admitted to trading on a regulated market;
- a common set of sanctions for market abuse offences.

The MAD II harmonises sanctions and sanctioning powers for certain insider dealing and market manipulation offences, as the EU-wide diversity in approaches before was a significant loophole. Effective sanctions can have a strong deterrent effect and reinforce the integrity of the EU's financial markets. This is the first legislative measure based on the new Article 83 paragraph 2 of the TFEU, which provides for the adoption of common minimum rules on

[1] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, OJ L 173, 12.6.2014. For an overview of the ITS and RTS, see: ec.europa.eu/finance/securities/docs/abuse/its-rts-overview-table_en.pdf

criminal law when this proves essential to ensure the effective implementation of EU financial market policies.

It is too early to pass judgement on the new rules, as they have only just come into effect. Critics argue that the new rules have not seized the opportunity to make a distinction between the use of privileged information for insider trading and for the duty of disclosure, and that the extension to MTFs and OTFs is not applied in the transparency directive, which governs general market disclosure rules by issuers, and thus creates an important inconsistency (see Di Noia et al., 2014).

4. Rules on short selling

The financial and sovereign crisis showed that a harmonised framework for short selling was not available. This was the case for banking stocks during the financial crisis, and for the sovereign debt of distressed states during the sovereign crisis. Short selling was seen to aggravate the downward spiral in shares or bonds prices, thereby rendering a recovery strategy more difficult. In addition, in several states there were no rules to stop the practice of uncovered short selling. Member states therefore adopted measures to tackle short selling and maintain financial stability, but these measures were not coordinated at EU level. The end-result was that the measures could thus be avoided by going cross-border.

The EU Commission, pushed by the Council, proposed a regulation in 2010 on short selling that was adopted in March 2012, with the provisions starting to apply from 1 November 2012.[2] Among other things, the regulation introduces a pan-European disclosure regime for net short positions in EEA listed shares and sovereign debt from certain thresholds onwards, as well as a restriction on uncovered short selling and a restriction on so-called 'naked CDS' positions in EEA sovereign debt. The regulation also allows EU member states to have clear powers to intervene in exceptional situations to reduce systemic risks and risks to financial stability and market confidence arising from the short selling of credit default swaps. The problem however remains that short selling plays a role in price formation of securities, and hindering this process thus prevents this.

5. Regulation of financial benchmarks

Cooperation between firms to fix financial benchmark rates could be considered a form of price agreement, which is illegal under EU law. However, when the Libor scandal broke, it seems that these forms of agreements between financial institutions were tacitly allowed, and that authorities trusted firms in their benchmark-setting activity, also for example for Euribor. Also in other sectors, benchmarks play an extremely important role, such as in commodities

[2] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps Text with EEA relevance, OJ L 86, 24.3.2012.

markets, but how these quotes were aggregated to form these benchmark prices remained very unclear, at least until recently.

The Libor scandal in July 2012, in the wake of the financial and economic crisis, required an immediate response on the part of the authorities. Multi-million-dollar and euro fines for illegal rate rigging were imposed on many banks, initially for Libor manipulation, later also for Euribor, by the US as well as EU and member state authorities, which amounted to at least $7bn. Coming after the massive support banks received during the financial crisis, this gave another knock to the image of the banking sector in the eyes of the public opinion. For a bank like Rabobank, which received a fine of $1bn, it led to a huge public debate, and an entire re-organisation.

International reaction was spearheaded by IOSCO, the international Organisation of Securities Commissions (IOSCO), which proposed detailed guidelines for the formation of benchmarks. In a series of 19 principles, published in July 2013, IOSCO focused on the process of benchmark formation, the methodology and the governance, while acknowledging that there is no one-size-fits-all method for its implementation over a variety of benchmarks.[3] As compared to pre-Libor times, this meant a huge adaptation for benchmark administrators, certainly for the critical ones, requiring a detailed and intensive process of covering, among other things, benchmark design, data sufficiency and hierarchy, internal oversight and review, and external audit.

At European level, ESMA took the lead in preparing a response, which led to a European Commission proposal in 2013. The regulation, which was adopted in April 2016, translates the IOSCO principles into EU law. Benchmark administrators are subject to prior authorisation and ongoing supervision, depending on the type of benchmark; they can set rules for the governance and transparency of the formation of benchmarks; and principles for the supervision of critical benchmarks. On the latter, it is regrettable that the European Commission did not dare to propose leaving the supervision to ESMA, given its expertise, and the global role of benchmarks, but instead left supervision to member states, many of whose supervisory authorities had no expertise on the matter.

The EU regulation distinguishes critical, significant and non-significant benchmarks. Critical benchmarks are used as a reference for financial instruments, or are based on submissions of contributors in the member states, on which the European Commission will decide in an implementing act at least every two years. Critical benchmarks require a mandatory administration process. The use of benchmarks formed outside the EU is subject to an EU equivalence process, covering the administrator, and an endorsement process of the benchmarks. Supervision is in the hands of competent national authorities in cooperation with ESMA, which is in charge of maintaining a register of benchmarks. Member states will cooperate in colleges for the supervision of critical benchmarks, with ESMA contributing to its effective functioning (Art. 47).

[3] See: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

6. Conclusions

The new market conduct rules are first and foremost an enormous implementation exercise for intermediaries and supervisors, and one may ask whether policymakers have tried to expunge too many sins with too few measures. In addition, the question arises as to whether the EU's supervisory structure is adapted to delivering a satisfactory outcome, given the experience with the implementation of investor protection rules of MiFID I, for example. As all the post-crisis updates essentially focus on strengthening market integrity, as compared to market efficiency, a strengthening of the supervisory structure will be required. This will be even more necessary if the EU wants to pursue its ambition to form a capital markets union.

MiFID II is an enormous expansion – in breadth as well as in depth. It proposes long-overdue measures to bring more price transparency to bond markets, but also the response to the G-20 commitments with regard to derivatives markets. Both may lead to further changes in the structure of securities markets in the EU, and increased competition between and integration of European capital markets.

But MiFID II will also increase transparency in securities markets through a reduction in waivers for off-exchange trading and increasing requirements for high frequency trading. Transparency will also increase through the requirement to unbundle expenses charged to investors, and the limitations on the funding of investment research through end-investors. These rules should be seen in conjunction with the growing importance of technology in investment services, which can allow for tailored and unbundled solutions.

Together with the updates to the market abuse directive, and the rules on short-selling and benchmark formation, the MiFID II rules should redress the balance of securities market rules much more towards market integrity, whereas market efficiency prevailed until before the financial crisis. Whether they will function and be effectively applied remains to be seen in the coming months and years.

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Table 1. Directive 2014/65/EU (MiFID II), Regulation (EU) No 600/2014 (MiFIR), the regulatory and technical standards, and delegated directives: a quick size comparison

		№ articles	№ pages	№ words in total (without annexes)
MiFID II Directive		97	148	73281
MiFIR Regulation		55	84	36859
RTS 1	transparency requirements for equity markets	20	20	8806
RTS 2	transparency requirements for non-equity markets	19	27	11792
RTS 3	volume caps	9	13	5194
RTS 4	trading obligation OTC derivatives	6	8	2639
RTS 5	equivalence for OTC trades	4	7	2618
RTS 6	organisational requirements for HFT by investment firms	29	22	8150
RTS 7	organisational requirements for HFT by trading venues	24	21	7687
RTS 8	market making rules for investment firms	8	10	3352
RTS 9	unexecuted orders	4	6	1655
RTS 10	co-location services and fee structures	6	6	1758
RTS 11	tick size regime for shares	6	9	3430
RTS 12	material market in terms of liquidity	2	5	1380
RTS 13	rules for data reporting services	21	22	8555
RTS 14	data reporting rules	2	5	1401
RTS 15	access to CCPs and trading venues	21	14	5585
RTS 16	access to benchmarks	6	9	2893
RTS 17	admission of financial instruments to trading	9	10	3520
RTS 18	suspension of financial instruments from trade reporting	2	6	1846
ITS 19	functioning of MTFs and OTFs	11	15	2820
RTIS 20	what are ancillary activities	6	10	4290
RTS 21	position limits for commodity derivatives	22	15	3712
RTS 22	transaction reporting	17	18	7550
RTS 23	data standards	8	7	2394
RTS 24	data maintenance for trading venues	14	9	3414
RTS 25	reference time formats for data venues	5	7	2058
RTS 26	information by trading venues on cleared derivatives	6	9	3169

RTS 27	information by trading venues on execution quality	12	15	5900
RTS 28	information by investment firms on execution quality	5	9	3422
RTS 1	authorisation information	11	13	4550
RTS 2	passporting notification	8	9	2918
RTS 3	cooperation between authorities	5	8	2752
RTS 4	registration of third country firms	4	5	1497
RTS 5	exchange of information between supervisors	5	8	2347
RTS 6	indirect clearing arrangements under MiFID and EMIR	2	22	3424
DD1	on clients funds, product governance and inducements	16	29	11359
DR1	organisational requirements and operating conditions	92	98	43778
DR2	market definitions	24	37	12965
total RTS, ITS , DA		471	563	206580
total level 1 and 2		623	795	316720
MiFIDII/MiFIDI		3.7		4.7

Source: http://bit.ly/2bREz2n, Casey and Lannoo (2006).