EVIA Response to ESMA Consultation Paper on MiFID II/ MiFIR review on the functioning of Organised Trading Facilities (OTF);

25 November 2020

Introduction

EVIA welcomes the opportunity to respond to this in depth review of the functioning of the OTF under MiFID2 and MiFIR not least because of the extensive interaction the association has had with the authorisation from the genesis and inception of the facility through to the granting of licences by NCAs under the auspices of ESMA's secondary markets standing committee. In this light we warmly welcome the outsized interest which this exercise has garnered across the European wholesale markets' stakeholder community, which principally stems from the opportunity to consider the nature of the multilateral perimeter.

This delineation in itself has been a principal matter of focus for EVIA and its members, and we note that our comments here do not seek repeat the series of related responses, comment letters and papers with which we have discussed with both ESMA and its committee members throughout the MiFID journey.

We would however reitierate the two core standing principles, firstly that whilst the supervision process itself benefits from proportionality, this occurs within the established perimeter and after licencing, it should not delineate it. Secondly, as a conduct legislation, MiFID licences and regulates the activity rather than solely the conclusions or outcomes.

Questions

Q1: What are your views about the current OTFs landscape in the EU? What is your initial assessment of the efficiency and usefulness of the OTF regime so far?

The OTF has been a useful and efficient addition to the legislative framework, providing a regulatory status to an important part of the market while recognizing the specifties of voice and hybrid electronic/voice execution models. OTFs play an important role in the interdealer market, allowing dealers to hedge their positions after serving clients in the dealer-to-client market.

For large or illiquid transactions in particular, the expertise and network of brokers allows these dealers to offload risk while limiting transaction costs. In the dealer-to-client markets, OTFs fulfil a similarly important role; helping investors (or other non-dealers) execute often compex transactions in an 'agency' capacity. The concept of discretion recognizes the importance of judgement and expertise, understood as a derivative of the requirements of best execution when they apply.

Q2: Trading in OTFs has been fairly stable and concentrated in certain type of instruments throughout the application of MiFID II. How would you explain those findings? What in your view incentivizes market participants to trade on OTFs? How do you see the OTF landscape evolving in the near future?

Wholesale market participants [ECPs and PCs] choose to access OTFs for the market knowledge and network that allows them to execute while limiting transaction costs. OTFs play a key role in the interdealer market, allowing dealers to manage risks efficiently, often by trading spreads, packages or seeking to hedge risk in its core economic terms. They are also important for the dealer-to-client market, where the operating firms may act on behalf of one client (in an agency capacity).

The stable market share of the sector as a whole demonstrates that, while technological progress enables more trading to happen electronically, the role of people (either as primary actors or in support of electronic execution) remains key; particularly when complex or large transactions are being arranged and negotiated.

Automatic, fully non-discretionary execution methods have been unable to fulfil that demand. The role of technology within the OTF (in a hybrid between human and electronic trading system components) is likely to increase. This is, for example, apparent in the success of volume matching; which is an electronic auction where the broker can propose a mid-price.

We emphasise that greater use would be made of the OTF if the rule requiring a single venue rate card were to be made more flexible, so that venue users/broker clients could adapt their trading requirements to a range of options. This very pertinent barrier to transitioning activity into the trading venue perimeter are unintended consequences that stem from the misapplication of costs and charges aspects of MiFID2 applying to retain distribution of manufactured financial products into wholesale markets for financial instruments which do not comprise customer undertakings. The supervisory approach to date fails to facilitate the interaction of different market participants and a variety of instruments which may be arranged as package transactions. Guidance is required to clarify the scope and situations where costs and charges aspects of investor protection should apply.

Q3: Do you concur with ESMA's clarifications above regarding the application of Article 1(7) and Article 4(19) of MiFID II? If yes, do you agree with the ESMA proposed amendment of Level 1? Which other amendment of the Level 1 text would you consider to be necessary?

Yes, EVIA does agree with the suggested approach. No further Level 1 amendments are necessary.

Q4: Do you agree with ESMA's two-step approach? If not, which alternative should ESMA consider?

Yes, EVIA does agree with the two-step approach and with the cited rationale behind it. Trade execution is not the activity, and it's the conduct which underlies consideration under MiFIR and MiFID2.

However, rather than issuing an Opinion, it would be even better if ESMA would cement its interpretation in a Regulatory Technical Standard (RTS). This would provide even more direction for supervisors than an Opinion and as such limit divergence.

It would also provide a process for further formal industry consultation. If an RTS would not be forthcoming, we would still encourage ESMA to consult the industry, which can help with practical advise and examples.

Q5: Do you agree with ESMA's proposal not to amend the OTF authorisation regime and not to exempt smaller entities? If not, based on which criteria should those smaller entities potentially subject to an OTF exemption be identified?

EVIA does agree with ESMA's proposal not to amend the OTF authorisation regime. Experience demonstrates that smaller entities are often able gain market share rapidly precisely because they are set up outside the perimeter, without rulebooks and not subject to supervision. This creates perverse incentives to avoid the regulatory perimeter, thereby increasing risk and decreasing transparency. For the avoidance of doubt, our opinion is that both rules-based and supervisory proportionality is due within the perimeter, but not that such a perimeter in itself applies differentially to firms carrying out the same activities.

Q6: Which provisions applicable to OTFs are particularly burdensome to apply for less sophisticated firms? Which Level 1 or Level 2 amendments would alleviate this regulatory burden without jeopardising the level playing field between OTFs and the convergent application of MiFID II/MiFIR rules in the EU?

EVIA's experiences to date, not only in the initial setup of OTFs, but from subsequent further licencing permissions within the EU27, have demonstrated that the authorisation requirements serve a general interest: improving investor protection and market transparency.

If certain requirements are unnecessary in light of these policy objectives, any alleviation should apply to the market as a whole and not single out a specific subgroup within the markets. Otherwise, risk will concentrate in those parts of the market which are outside of the supervisory scope.

Q7: Do you consider that ESMA should publish further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services (primarily Reception and Transmission of Orders and Execution of orders on behalf of clients)? If yes, what elements should be considered to differentiate between the operation of multilateral systems and these other investment services?

EVIA believes that the distinction between venue operation and other investment services is sufficiently clear and does not require further guidance. For background, EVIA members are authorised as limited activity investment firms and, on occasion, act in both capacities. In this case, they would arrange trading interests above LIS outside of a trading venue for the purpose of submitting concluded trades onto a trading venue which accepts pre-arranged transactions. This follows from ESMA's position that there should be a single trading venue for the execution of a trade (or the relevant component of a strategy/package trade).

It would be unhelpful to treat the activity of the broker, taking place outside of a trading venue but with the aim of transmitting qualifying matched interests to that trading venue, as part of the trading systems of the venue. Where such activity would, on its own, amount to a multilateral system, then it ought to be treated as a multilateral system under licence to the person operating it; the exception being when the system is being used to submit pre-arranged matched trading interests to a trading venue that accepts them (for example, where the transaction is above block size). Without this exception, there would be a proliferation of multilateral systems: trading venues which attract arranging activity, originating outside of their own trading systems, would be orbited by satellite MTFs and OTFs (depending on the methods being used to pre-arrange transactions) that only exist to send them pre-arranged trades.

What is key is that the relevant trade is arranged under the rules of a trading venue and is ultimately executed on or under the rules of the venue.

Q8: Do you consider that there are networks of SIs currently operating in such a way that it would in your view qualify as a multilateral system? Please give concrete examples.

No response to question 8.

Q9: Do you agree that the line differentiating bilateral and multilateral trading in the context of SIs is sufficiently clear? Do you think there should be a Level 1 amendment?

No response to question 9.

Q10: What are the main characteristics of software providers and how to categorise them? Amongst these business models of software providers, which are those that in your view constitute a multilateral system and should be authorised as such?

EVIA supports activity based regulation which does not regulate software providers on how they characterise themselves, but rather on what activities they undertake. As such, we would categorize them in two buckets: those that engage in multilateral activity (and therefore should be regulated as venues) and those that do not.

In order to determine whether they fall in the first or the second bucket, it is helpful to distuinguish between two types of software companies: those that provide distributed trading mechanisms and those that provide insourced trading mechanisms.

Distributed Trading Mechanisms

A model has been seen, whereby a technology provider makes available to its clients technology that enables trading interests entered by each client to be made visible to and actionable by other clients.

The argument appears to be that, in this model, the technology provider is not operating a system for the purposes of MiFID II. The software is licensed to each of its clients, and their interactions are cast as bilateral because they are client-client/peer-peer.

These arguments are spurious and demonstrate a poorly-conceived attempt to evade the regulatory perimeter. While there is no question that the simple provision of technology, such as an order management system, is not within the trading venue perimeter, this technology is clearly provided and serviced for the purpose of bringing together the trading interests of multiple clients in order to lead to transactions in ways prescribed by the software logic.

It should make no difference under MiFID II whether the provider or a system or facility does so on a client-server or peer-peer distributed basis. If the nature of the system is to allow the trading interests of multiple users to interact, then it must be a multilateral system. It likely also involves the regulated activities of reception and transmission of order and/or execution of orders on behalf of clients.

Insourced Trading Mechanisms

The second case that needs to be considered is the insourced trading mechanism. The provider of such mechanism allows multiple buyers and sellers to interact, but under the supervision and control of an investment firm which has procured the service from the provider.

One of the better-known examples of this, but by no means singular, is Trayport, one of the leading software networks for the wholesale energy markets in Europe and provides for OTC, OTF, MTF and RM connectivity. Trayport is not a multilateral system in and of itself, it is an insourced trading mechanism. Their technology forms part of the broker's own system, which may be a combination of voice and electronic components.

The broker retains the regulatory responsibility within the perimeter and needs either a venue and/or 'reception and transmission of orders' authorization. The provider of the insourced trading mechanism does not.

Q11: Do you agree with the approach suggested by ESMA regarding software providers that pre-arranged transactions formalised on other authorised trading venues? Do you consider that this approach is sufficient to ensure a level playing field or do you think that ESMA should provide further clarifications or propose specific Level 1 amendments, and if so, which ones?

In our assessment, EVIA considers that all firms who arrange transactions in the jurisdiction ought to be within the scope of MiFID II and therefore authorised as investment firms. Whether

such firms provide software or not is neither here nor there. Where transactions are pre-arranged and submitted to an authorised trading venue, all under the rules of the trading venue, then the ESMA Q&A clearly already addresses the situation. (ESMA Q&A 11, MIFID II/R transparency topics).

Q12: Do you agree with the principles suggested by ESMA to identify a bulletin board? If not, please elaborate. Do you agree to amend Level 1 to include a definition of bulletin board?

EVIA does agree with ESMA's proposals. The description of the bulletin board as set out is neutral and on its own would not constitute a trading venue.

Since MiFIR constitutes a conduct regulation, we underscore our view that it is the activity that a person may undertake, rather than such a tool standing alone, which may or may not enter the perimeter depending on whether such activity constitutes a multilateral system to bring together third party interests with a view to forming a contract. The concept of forming an "invitation to treat" is helpful in this regard.

Q13: Are you aware of any facility operating as a bulletin board that would not comply with the principles identified above?

EVIA is not aware of any such facility.

We add that should such a bulletin board act as a "click to trade" system, one which therefore connected interested parties to the offering party then such a facility could indeed approach the description of a marketplace where it departs from a natural agency model.

This is because those approaches would form an "invitation to treat" or an expression of willingness to negotiate. Such arrangement activity, based on a system with multilateral participation, becomes relevant under MiFIR absent any regard for either a formal membership, nor a published rulebook. The perimeter therefore turns on the application of the "rules of the system," which may be implicit.

For the avoidance of doubt, the broadcast of customer "Axe Sheets" in the manner described in this ICMA practice paper, would require further formalisation of expectations and the interactions of parties to entreat into any system perimeter.

Q14: Market participants that currently operate such systems are invited to share more detailed information on their crossing systems (scale of the activity, geographical coverage, instruments concerned, etc…), providing examples of such platforms and describing how much costs & fees are saved this way as opposed to executing the relevant transactions via brokers or trading venues.

From among EVIA's members, TPICAP operates the TrueQuote platform, allowing for global transactions. The platform sees the greatest activity from European and UK asset managers, coming from areas where crossing rules are clearest. Coverage ranges from global corporate

and sovereign bonds (hard and local currency), as well as securitised bonds. On this platform, crosses are executed using a third-party mid-price as a reference to ensure fair treatment for both the buying and selling funds.

Q15: Do you consider that internal crossing systems allowing different fund managers within the same group to transact between themselves should be in scope of MiFID II or regarded as an investment management function covered under the AIFMD and UCITS? Please explain. In your view, should the regulatory treatment of these internal crossing system be clarified via a Level 1 change?

No response to question 15.

Q16: Do you agree with the interpretation provided by ESMA regarding how discretion should be applied and do you think the concept of discretion should be further clarified?

EVIA does agree with ESMA's interpretation and we do not see a need for further clarification.

Q17: For OTF operators: Do you apply discretion predominantly in placement of orders or in execution of orders? Does this depend on the type of trading system you operate? Please explain.

EVIA underscores that both applications of discretion are relevant to the day to day operation of OTFs given that system personnel operate within the trading venue perimeter ["trading venue personnel"]. We note that the application of discretion depends upon the mode of transaction arrangement and of trade execution occurring within the venue and therefore the governance under the relevant aspects of the rulebooks, and it is therefore wide ranging.

We add that to date, the approach has proved suitable in the experiences of member firms.

Q18: For OTF clients: Do you face any issue in the way OTF operators exercise discretion for order placement and order execution? If so, please explain. Does it appear to be used regularly in practice by OTF operators?

No, EVIA members have not faced any issues when exercising discretion for order placement and order execution in their operations of OTFs. We reiterate that indeed; discretion is used widely and regularly by trading venue personnel to facilitate the ordinary operation of the trading venue.

Q19: Do you think ESMA should clarify any aspect in relation to MPT or that any specific measure in relation to MPT shall be recommended?

EVIA does not believe any clarification is needed.Indeed we would add that recent events in bond markets, and their associated funding and hedging markets have provided a significant stress test to the operational resilience of the MPT model.

Q20: In your view what is the difference between MPT and riskless principal trading and should this difference be clarified in Level 1?. In addition, what, in your view, incentivizes a firm to engage

in MPT rather than in agency cross trades (i.e. trades where a broker arranges transactions between two of its clients but without interposing itself)?

Matched principal trading is a subset or species of riskless principal trading.

Riskless principal trading describes the situation in which a firm receives an order from a client to buy or sell a security and then sources the security or sells the security in the market as principal. The method was described by NASDAQ at the turn of the last century to distinguish the reporting obligations of riskless principal trading from the "at risk" trading of market makers:

- *"In NASDAQ, a riskless principal trade is one in which a broker/dealer, after having received an order to buy (sell) a security, purchases (sells) the security as principal, at the same price, to satisfy that order. The broker/dealer generally charges its customer a markup, markdown, or commission equivalent for its services, which is disclosed on the confirmation required by Securities Exchange Act (Exchange Act) Rule 10b-10."*

Matched principal trading, as the term is commonly used in the interdealer markets, describes the situation in which a firm matches two offsetting client interests in different directions (buy and sell) and then interposes itself as the mutual counterparty to each of the legs. In a matched principal transaction, the intermediary acts as a principal only fleetingly ("simultaneous") to fulfil the instructions of the clients.

Wholesale markets provide for three main incentives for matched principal trading, as compared to name give-up transactions covering the matters of price, size and credit:

1. Anonymity of the buyer and seller helps to ensure an orderly market.
2. Package, spread and complex transactions can be arranged involving multiple trade legs in order to satisfy the extent, timing and shape of a client interest.
3. The buyer and seller can each look to the intermediary facilitating the transaction when assessing their credit risks, rather than needing to analyse the positions of all possible counterparties.

Q21: Do you agree with ESMA's proposal to clarify that the prohibition of investment firms or market operators operating an MTF to execute client orders against proprietary capital or to engage in matched principal trading only applies to the MTF they operate, in line with the same wording as applicable to regulated markets?

The position explained by ESMA is consistent with EVIA's understanding of the way that the rules are interpreted and applied generally. We agree that clarification of this position will be helpful.

Ends.