FESE response to the ESMA consultation paper on the functioning of the OTF regime

25th November 2020, Brussels

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?

N/A

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 incentivises market participants to trade on OTFs? How do you see the OTF landscape evolving in the near future?

N/A

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?

While the scope of OTFs is limited to the trading of non-equity products, we agree with ESMA that this consultation should generally address the setup of trading systems, the trading landscape and the authorisation process. With this in mind, it is instructive to recall the original MIFID II goals. As outlined in the recitals[1], the aim was to establish a comprehensive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used to conclude those transactions so as to ensure a high quality of execution of investor transactions and to uphold the integrity and overall efficiency of the financial system. One of the key pillars of investor protection is ensuring trade execution takes place at a price based on well-informed order flows. Securing such effective and reliable price formation relies on transparent and liquid markets. While a range of trading venues contributes to the price formation process in Europe, Regulated Markets hold a central role in guaranteeing the core price formation process upon which the market relies. Indeed, it also enables many other venues to offer alternative competing execution channels to the market. When it comes to equities market structure, MIFID II sought to strengthen price formation by moving dark trading to transparent multilateral trading venues. The legislation set out to achieve this by banning Broker Crossing Networks (via the share trading obligation or STO) and restricting activity on dark pools (via the double volume cap or DVC).

[1] DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, Recital (13).

However, the MiFID framework has, despite its objectives, failed to strengthen the price formation process. This failure is rooted in market structure issues which should be the subject of a thorough analysis and review. Addressing and resolving issues around market structure will, in our view, have a much greater impact on the transparency of European capital markets and the price formation process than other proposals such as the consolidated tape, which have been nonetheless touted as the single silver bullet to all issues pertaining to transparency and price formation.

In this sense, we welcome ESMA's decision to tackle some of the issues at the core of the market structure debate in this consultation and lay out our views on the questions on definitions and supervisory convergence as raised in the paper below.

ESMA rightly addresses the disparity in the markets when it comes to the authorisation of multilateral systems. We support the approach suggested by ESMA (paragraph 41) to move Article 1(7) of MiFID to MiFIR. We agree that divergences in national implementation as well as in supervisory approaches need to be avoided. Only with a convergent approach towards the authorisation of multilateral trading venues, creating a level playing field and equal protection of investors, can a true Capital Market Unions emerge.

Not only do we support the move of the provisions to MiFIR, we believe more steps need to be taken in order to further enhance investor protection. The concept of multilateral trading is essential to this discussion. We have witnessed the emergence of platforms within scope of MiFID II/MiFIR that interpret the concept of "multilateral trading" differently. This is fundamentally inconsistent with the notion of a Single Market and needs to be addressed. Its persistence poses challenges to investor protection, particularly in cases of platforms offering retail trading, and the principle of a level playing field.

Therefore, we support ESMA's suggestions pursuant to questions 8 and 9. When it comes to ESMA's intention to clarify in addition the conditions under which a facility should request authorisation as a multilateral system, it should be ensured that any loopholes are closed and existing regulation is enforced. We would also welcome ESMA ensuring supervisory convergence in the trading landscape via its many tools available in order to safeguard equal investor protection.

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

Please see our answer to the previous question.

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?

N/A

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?

N/A

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?

N/A

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.

We fully support the spirit of MiFID II/R to promote transparency and firmly differentiate between bilateral and multilateral trading activity in order to deliver a true level playing field. As highlighted in our responses to the recent ESMA Consultation Papers on the MiFID II/R Review Reports on transparency, we believe that potential gaps in the application and enforcement of the SIs legislative framework to the detriment of transparent trading may warrant further attention. It has been observed that BCN trading volumes under MiFID I have shifted to SI reported trading instead of moving to multilateral trading venues which is concerning. While SIs are regulated under MiFID II as execution venues providing bilateral trading, they provide less transparency than on-exchange trading. This can be problematic when the distinction between purely bilateral and hybrid multilateral trading is blurred. In theory, every trade in an SI must take place against the proprietary account of the operator. And as highlighted by ESMA in the consultation paper, SIs are prohibited, when dealing on their own account, from entering into matching arrangements with entities outside their group with the objective of carrying out *de facto* riskless back-to-back transactions in financial instruments outside trading venues. In this context, ESMA and the Commission have taken much-appreciated steps to ensure that SIs only engage in purely bilateral activities. However, the impact of these clarifications still seems to be unclear, and there seems to be no clear view from a market supervisory and regulatory perspective on the existence and relevance of SI networks. This raises concerns about the still prevailing opacity around SI activities. We would therefore welcome close monitoring and assessment of those activities and whether they qualify as multilateral systems. Should authorities conclude that SI networks exist, we would welcome them to be subject to a broader review of the SI regime with a view to increase transparency. One potential starting point could be a requirement for investment firms to seek authorisation as an SI. The authorisation procedure should include a description of the SIs business activities, including amongst others information on the condition of executing orders, interactions between SIs and other execution venues, compliance with best execution requirements, etc. It could also be helpful to regularly assess the compliance with the authorisation requirements and to grant competent authorities the possibility to request further information if required. If SI activity is not strictly contained to bilateral trading, there could be lasting negative implications on European markets regarding price formation and transparency. In this regard, we would like to flag again some concerns regarding long-term trends in the SI sector:

- On the non-compliance lessons learnt from the US: At this point in time, the proportion of trading on "lit venues" is much lower in Europe than in the US and Asia, this provides a clear indication of how fragmented and opaque markets are in Europe to the detriment of issuers and investors. This is cause for concern.
- On the process by which an entity applies to become an SI: There would be merit in making this process more thorough since it would appear that a tick-box approach is sufficient. Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs), in contrast, need to fulfil much more elaborate descriptions of the planned business activities. As per the above, we would argue that appropriate supervisory oversight of SI activity should start here as well as address the potential issues outlined above that can appear when SIs carry out their business activities.

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?

As alluded to in our answer to question 3 and question 8, FESE believes that the concept of multilateral systems is interpreted differently and concludes that fostering a uniform understanding of the differentiation of multilateral vs bilateral systems would be helpful.

In addition to the suggestion above to consider the introduction of an authorisation procedure for SIs, competent authorities should carefully monitor if systems registered as bilateral systems operate as such and do not engage in any multilateral activities. The same scrutiny should apply to operators of multilateral systems for a level playing field.

Should the authorities come to the conclusion that a clear identification of bilateral systems is not possible, they might want to consider introducing a definition of bilateral activities into the legal framework to clearly differentiate from multilateral systems.

Having said that, we generally welcome ESMA's reflections on the need to amend the Level 1 text to further clarify the definition of an SI. We would suggest broadening the scope of such reflections to include the perspective of equity markets. On these markets, data shows a decrease of continuous lit order books, while the combined share of OTC and SI trading keeps growing. Once again, this contradicts the objective of MiFID II/MiFIR to significantly improve transparency by bringing more trading to lit multilateral trading venues.

We strongly believe that a simplified market structure would strengthen lit markets, support active price formation and the generation of robust reference prices. To achieve this, we would like to reiterate the concept that we detailed in our past responses to ESMA:

For Equity Markets

More than two years after the implementation of MiFID II/R, transparency has not improved, while SIs have proliferated. The trading landscape has become more fragmented under MiFID II and the market share of the continuous lit order book (CLOB) has decreased.

Against this backdrop, FESE suggests restricting trading in SIs to above (or at least up to a percentage of) LIS only for equity and equity-like instruments in order to preserve the price formation process all the while acknowledging the need for bilateral trading.

Standard orders below (or up to a certain percentage of) LIS would exclusively be executed on RMs and MTFs, subject to full transparency requirements and contributing to efficient price formation. In this scenario, trading above (or at least up to a percentage of) LIS would constitute a legitimate dark space for the execution of larger order sizes.

Our proposal aims to simplify the fragmented trading landscape, as below LIS trades should contribute to price formation given the limited market impact. This type of trading should operate in a trading venue, under non-discretionary and non-discriminatory rules, and comply with the tick size and transparency regimes.

In general, SIs should be more tightly regulated and should have transparent and comparable reporting so that investors and regulators could verify best execution claims. OTC would be restricted to trades not subject to the share trading obligation (STO). The MMT standard should be extended to all execution venues as well as to OTC transactions under ESMA's governance. Furthermore, OTC and on-venue transactions should reach the same level of quality in post-trade reporting to facilitate the *consolidatability* of data. All transactions identified as not contributing to the price discovery process should have an individual flag in FITRS.

All these measures would increase transparency and improve price formation and investor protection to the benefit of the market as a whole, as the more participants that actively contribute to the lit price formation process, the more valuable it becomes.

There would no longer be a need for a double volume cap (DVC) mechanism: Pre-trade transparency waivers would be limited to the LIS waiver, which protects from market impact, and the order management facility (OMF) waiver, as orders in an OMF facility ultimately become pre-trade transparent and contribute to price formation.

At the same time, we acknowledge that there is a need to address the concerns of institutional investors in the middle ground between retail size orders and the large-in-scale market. Alongside ensuring price discovery, the interests of these stakeholders could be served by:

- Consideration of a broader range of market models in this space.
- A lowering of the relevant threshold above which transparency is waived for large transactions.

For Bonds and Securitised Derivatives Markets

Bonds and securitised derivatives trading is still opaque and there was no increase in transparency triggered by MiFID II compared to MiFID I. This is the case for SI trading where there is seemingly no pre- and post-trade transparency available. Transparency on SI quotes (and prices) in bonds and securitised derivatives is established by SIs via proprietary means, via their websites, via ECN-like networks or has not to be established at all (for illiquid bonds). This conflicts with the aim to increase transparency in the traditionally opaque markets in these instruments. Therefore, FESE strongly supports ESMA's proposal to define the requirements that should be met by SIs in non-equity instruments for publishing their quotes and to extend the requirements set out in Article 13 of Regulation 2017/567 on obligations for SIs to make quotes easily accessible to SIs in non-equity instruments.

FESE also supports ESMA's conclusion in the Report on non-equity transparency to delete the SSTI concept for non-equities and replace the references to this concept for the SI quoting obligation with a reference to the pre-trade LIS threshold in return. In order to adequately counterbalance the effects of such proposal, we support ESMA's proposal to lower the pre-trade LIS threshold. In this context, FESE welcomes that ESMA would further engage with stakeholders to determine appropriate pre-trade LIS thresholds, possibly with different levels depending on the asset class.

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?

N/A

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?

N/A

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?

N/A

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

N/A

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.

N/A

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?

N/A

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?

N/A

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.

N/A

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?

N/A

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?

N/A

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)?

N/A

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?

N/A