
Position Paper

Organised Trading Facilities: Ensuring Investor Choice

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1. Introduction

In MIFID 2, the European Commission (Commission) proposes to create an additional category of trading venue called the Organised Trading Facility (OTF). The policy intention behind the new category is to ensure that all organised trading is brought into the regulatory framework, and to ensure a level playing field with other trading venues ,i.e. Regulated Markets (RM) and Multilateral Trading Facilities (MTF).

Specifically, the OTF is intended for both equity and non-equity markets to provide organised trading systems characterised by discretionary execution of transactions with an appropriate regulatory framework, distinct from that of RMs and MTFs.

2. Key Points

AFME supports the OTF category for **equities and non equities**, subject to certain issues being addressed (discussed further below).

The OTF is necessary and important because a significant measure of organised trading in equities and non-equities is not appropriate for RMs or MTFs:

- In the equities market, the OTF will provide a more transparent and well regulated environment within which broker crossing systems will be able to operate.
- For non-equities, the majority of instruments do not trade continuously, and are therefore not suitable for trading on RMs or MTFs. The OTF will provide a regulated trading platform where such trading can be accommodated.
- The OTF will provide a regulatory venue for voice-hybrid systems in the equity and non equity markets.
- It allows for different models to exist in a flexible regulatory framework and will therefore preserve choice for the end investor because the regime is clearly differentiated with the RM and MTF regime in the ability to exercise discretion in the way in which a quote or order is handled and a trade is matched within the venue.
- Without an OTF, the existence of an important set of systems which exist to fulfil investor demand would be put at risk

If designed correctly, the OTF will ensure investors have continued flexibility as to their preferred execution method, whilst bringing a wider range of trading practices within the scope of a regulated venue structure.

Referring to the need to ensure the OTF operator's neutrality, the Commission proposes to ban the operator from trading against his own proprietary capital. **AFME considers the deployment of own capital in an OTF as critical for the facilitation of investor business in equity, fixed income and derivative markets – and for this reason is something which investors explicitly demand from the investment firms they trade with.**

On that basis, AFME advocates that the proposed ban be removed and that the Commission's concerns regarding operator neutrality be achieved through the operator's application of conflicts of interest, client order handling and best execution rules as well as a client choice regime limiting client interaction with operator own capital to instances where the client agrees.

3. Benefits of the OTF Regime

The ability to exercise discretion is a key element of the OTF regime. It allows the operator to provide a tailored service giving greater choice to their clients by allowing discretion over permitted executions.

3.1 Discretion over permitted executions

The discretion of the operator is critical for investor choice. It would allow for:

Interaction: OTF operators, or investors themselves can select **the type of participants a given investor wishes to interact with.** Market participants would be classified by the operator into groups with similar characteristics. This would allow an operator to exclude certain of its clients from his venue whose trading strategies may be contrary to the overall interests of his existing clients.

In the equities market for example, typical groupings of participants may include:

- **client facilitation** - business resulting from other clients of the OTF operator
- **external client** - clients permitted to access the venue that manage investments for their clients
- **proprietary** - representing the proprietary trading interest of the OTF operator (assuming the ban on use of own capital is lifted)
- **external proprietary** - representing clients permitted to access the OTF that are third party proprietary traders

In fixed income, this discretion would preserve the integrity of the wholesale interdealer markets. Should operators *not* have discretion over the nature of permitted participants the distinction between interdealer and the dealer to customer markets would be blurred, making it more difficult for market makers to service their clients. The key function of the interdealer markets is to enable market makers to manage the amount of capital that they put at risk to

provide liquidity to their customers. Every bond a market maker buys from an investor is held in inventory and will need to be sold at a later stage. In the meantime, the market maker faces the risk that interest rates or market conditions might cause a decline in value of the bond that they hold in inventory. Fluctuations in market price between a buy and a sell transaction are an inventory risk that needs to be hedged.

Method of execution: operators would have flexibility to choose between multiple methods to execute transactions (e.g. limit order book, Request For Quote system etc) using the interplay between voice trading, full electronic or a hybrid of the two in order to achieve best price for their clients. Additionally, operators would have the flexibility to split the orders in order to achieve the optimal execution.

- **Voice Broking:** Trading by voice is one important mechanism through which investment firms execute business. In particular, voice trading (as opposed to electronic trading) is an essential execution method by which market makers hedge their risks. The role of the market maker is to facilitate client orders; if hedging of risk becomes more difficult this would result in higher transaction costs and higher borrowing costs for investors, including governments. Trading via voice is especially important during times of market stress, when immediacy of execution becomes more important (and frequently trades are executed against the risk capital of the broker).

Best execution: the ability to exercise discretion; together with the use of own capital allows investment firms to meet their best execution obligations vis a vis their clients.

Settlement: trades on discretionary trading services may be settled bilaterally or through a CCP in accordance with the operating model chosen by the operator. On an exchange operated regulated market, the majority of trades are cleared through a CCP, with no client choice available.

4. Pre trade transparency for OTFs

The proposed MiFIR requires OTFs to make current bid and offer prices and the depth of trading interests at those prices for orders or quotes advertised through their systems publicly available on a continuous basis. Regulators will be able to waive the obligation based on the market model and products' liquidity.

AFME welcomes the flexibility of the transparency regime for OTFs, allowing different levels of transparency be applied depending on the market model. **The tailored application of pre trade transparency requirements by market model is particularly important in the context of voice broking. This important activity should not be constrained through the application of pre trade transparency requirements.**

This is also appropriate for the quote-driven trading model in fixed income. In the fixed income markets, the platforms allow clients to raise a request for quote to single or multiple dealers in competition and select the best price. These platforms also provide benchmark, composite and indicative pricing on a continuous basis. We believe that this information provides sufficient price discovery to clients and meets the pre-trade requirements for 'quote driven' systems.

5. The importance of OTF operators' own capital usage

The key function of the OTF operator's own capital is to ensure client execution when there is no simultaneous two-way end-user market. The number of buy orders placed by investors for a security at any one time rarely matches the number of sell orders, especially in times of market stress. Prohibiting operators from providing their own capital to match clients' orders would therefore impede the effective functioning of markets.

Fixed Income and Derivatives

Unlike a single class of shares, each fixed income security is dissimilar in terms of maturity, coupon, interest rate, liquidity, and rating. This creates imbalances in the number of buy and sell orders placed by investors for a bond at any one time, especially in the current time of market stress. In this context, dealers' own capital has a crucial role in ensuring continuous markets and allowing client's orders to be matched gradually over time, reduce time to execution and enhance the cost and quality of transaction for the customer.

The OTF category aims to inter alia deliver a new venue to markets outside the cash equity markets. As the vast majority of non-equities instruments do not trade continuously, and therefore are not suitable to trade on RMs or MTFs, the ability for venue operators to deploy their own capital is crucial to the achievement of the objective and to deliver the G20 derivatives trading commitment.

Equities market

In the **equities market**, many investment firms, particularly the larger firms with the widest service offerings, facilitate their clients' business through dealing with the customer on a principal to principal basis. Investment firms do this because it has been explicitly requested of them by their clients.

There are a number of benefits to the investor dealing with an investment firm on a principal basis, including:

- **access to risk capital** - where the immediacy required by the investor is not available from the central market place, the investor may for large orders ask the investment firm to use its risk capital to execute the trade. The investment firm will subsequently manage the order into the market over a specified time period
- **single trading counterparty** - all trading activity can be consolidated, irrespective of the trading counterparty for any resultant onward trades. This results in:
 - **improved risk management** - the counterparty risk exposure for each trade is the investor's chosen investment firm; and
 - **simplified post-trade** - clearing and settlement activities are consolidated, irrespective of the number of trading counterparties for initial or resultant onward trades, offering greater efficiency and lower costs

- **access to other clients' liquidity** - the investor may wish to trade with other clients of its chosen investment firm on an anonymous basis and without counterparty risk exposure to those clients.

AFME recommendation

For the reasons stated above, OTF operators should be allowed to deploy their own capital, and investors should be given the option as to whether their orders interact with this capital.

Given the potential conflicts that could arise in both the above cases, robust risk control procedures should be in place, as required by existing MiFID rules on 'Conflicts of Interest', 'Client Order Handling' and the 'Obligation to execute orders on terms most favourable to the client'. This would ensure that an investment firm would be participating on its own OTF in the same way as any other market participant.

6. Ensuring clients' interests are not compromised

The services described above can occur manually but some of these transactions are arranged within a firm's automated systems (such as broker crossing networks in the equities market). These manual processes and automated systems are already to a large extent subject to regulation under MiFID.

Conflicts of interest can occur within investment firms but controls are put in place so they can be identified and managed appropriately. They may occur between the following divisions and activities in a bank: customer trading and proprietary trading activities; proprietary trading and investment banking activities; and M&A and research departments. Conflicts of interest may also occur on existing venues such as MTFs and Broker Crossing Networks; for example between the operator of a venue and the operator of brokerage activity.

The above conflicts are managed by extensive policies setting out how to identify circumstances which may give rise to conflicts of interest; establish mechanisms and systems to manage those conflicts; and prevent actual damage to clients' interests. Escalation processes are in place to ensure that senior management and/or the regulator are alerted to any actual or potential breaches. Transaction monitoring is conducted, with the focus being on the front office to identify suspicious transactions.

Both the Market Abuse Directive and MiFID harmonise and codify these policies by requiring investment firms to manage conflicts where they may damage the interests of the clients or potential clients of the investment firm.

The table below provides a series of examples of existing measures that are currently in place to manage conflicts of interest within an investment firm.

Potential conflict	Measure in place
Between the operator of a venue and the operator of brokerage activities	<i>Business segregation</i> – Persons tasked with the management responsibility of an MTF do not hold any trading or sales trading responsibilities.

When the investment firm engages both in customer trading and proprietary trading activities	<i>Business segregation</i> – these activities are undertaken by separate departments operating with appropriate independence from one another. <i>Client orders handling rules</i> - the investment firm has in place guidelines dealing with customer order priority.
When the investment firm engages both in proprietary trading and investment banking activities	<i>Business segregation</i> – these activities are undertaken by separate departments operating with appropriate independence from one another. <i>Client orders handling rules</i> - the investment firm has in place guidelines dealing with customer order priority.
When the operation of a venue requires input from other staff across the investment firm	<i>Information barriers</i> – There are effective procedures in place to control the flow of information where, otherwise, the risk of a conflict of interest may harm the interests of a client.
When the investment firm deals ahead of a client order, when the order previously submitted by its customer will predictably affect the price of the security with the purpose of taking advantage of advance knowledge of that client order (front running).	<i>Information barriers</i> – There are effective procedures in place to control the flow of information where, otherwise, the risk of a conflict of interest may harm the interests of a client.

Application to the OTF category

Conflicts of interest have been cited by policy makers as a justification for placing limits on proprietary capital interacting in an OTF. While potential conflicts may arise as a result of the deployment of own capital by investment firms within their own OTFs, these can be efficiently managed through the rules cited above on conflicts management, market abuse and order handling. MiFID Art. 27 '**Obligation to execute orders on terms most favourable to the client**' enshrines the principle that firms should always place the interests of their clients ahead of their own.

The most significant concern with respect to conflicts is front-running, where firms prioritise the matching of their own orders before client orders while taking advantage of advance knowledge of those pending client orders. This may happen when the order previously submitted by the client will predictably affect the price of the financial instrument.

Front running is a form of market abuse, which is regulated under the Market Abuse Directive. To comply with the Directive, firms must maintain internal anti market abuse systems and controls. These consist of policies in relation to information barriers, coupled with automated means of monitoring proprietary/house trading against restricted lists. Second, escalation processes are in place to ensure that senior management and/or the FSA are alerted to any

actual or potential breaches. Third, transaction monitoring is conducted to identify suspicious transactions.

Current conflicts of interest rules and client order handling rules are sufficiently robust and always require investment firms to act in the best interests of their clients. The objectives of neutrality and duty to the client can be fulfilled by applying these rules to OTFs. AFME would however welcome the opportunity to participate in any process that was looking to improve or strengthen such rules.

6. OTFs and MTFs are substantively different and should co-exist

Different trading categories fulfil different purposes for investors. In a MIFID 2 scenario, MTFs and OTFs would co-exist alongside each other. Whilst the OTF regime would be able to provide a bespoke service to investors, trading would still continue to take place on MTFs and RMs where there is the greatest amount of liquidity available. In the context of the development of broker crossing systems (BCS) in the equities market - this has only resulted in them attracting 3-5% of total European turnover¹ in contrast to the ~25% attracted by MTFs (and ~60% retained by RMs). Thus, whilst their portion of turnover is small, they provide an important service to the end investor.

The creation of the OTF would also prevent the risk of further market fragmentation through the proliferation of multiple niche MTFs serving specific market needs. It would also serve to prevent fragmentation between MTFs and Systematic Internalisers.

Concerns about the negative impact on price formation in the equities market are unfounded; OTFs would make use of the reference price waiver, where execution points would be determined with reference to the primary lit (i.e. pre trade transparent) venue. Therefore, the price formation is passive only and not detrimental to the quality of the market. This sits in contrast to the current situation where Broker Crossing Systems currently operate OTC and may therefore execute at any price point; the OTF category would therefore enhance market quality.

It would also be inappropriate to require OTFs to convert to MTFs upon reaching a volume threshold. These activities are functionally different. The business model of a MTF, which provides non-discretionary trading between multiple parties, is entirely different to the business model of an OTF, where capital is provided to facilitate client orders and operation is on a discretionary basis. In the latter case, the matching of client to client orders is minimal in comparison to the client to broker interactions. Individual products and sectors will naturally find the appropriate platform; the shift from OTF to MTF should be a natural evolution and should not be forced after reaching a specific threshold.

AFME is of the view that the existing flexibility in trade execution methods enables market participants to provide and access liquidity through non-electronic platforms in times of market stress and also allows markets to move to electronic platforms in normal market circumstances.

¹ The Nature and Scale of OTC Equity Trading, *AFME*