



European Securities and  
Markets Authority

# Reply form for the ESMA MiFID II/MiFIR Consultation Paper





European Securities and  
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Date: 22 May 2014



## Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA MiFID II/MiFIR Consultation Paper, published on the ESMA website ([here](#)).

### **Instructions**

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

- i. use this form and send your responses in Word format;
- ii. do not remove the tags of type <ESMA\_QUESTION\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- iii. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- i. if they respond to the question stated;
- ii. contain a clear rationale, including on any related costs and benefits; and
- iii. describe any alternatives that ESMA should consider

Given the breadth of issues covered, ESMA expects and encourages respondents to specially answer those questions relevant to their business, interest and experience.

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **1 August 2014**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

### **Publication of responses**

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

### **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Disclaimer’.



## 1. Overview

## 2. Investor protection

### 2.1. Exemption from the applicability of MiFID for persons providing an investment service in an incidental manner

**Q1: Do you agree with the proposed cumulative conditions to be fulfilled in order for an investment service to be deemed to be provided in an incidental manner?**

<ESMA\_QUESTION\_1>

#### AFME Response

Yes, we agree with the advice and believe it may be helpful in creating a level playing field for the provision of investment services.

<ESMA\_QUESTION\_1>

### 2.2. Investment advice and the use of distribution channels

**Q2: Do you agree that it is appropriate to clarify that the use of distribution channels does not exclude the possibility that investment advice is provided to investors?**

<ESMA\_QUESTION\_2>

#### AFME Response

We agree with ESMA that there is no need to revise the definition of investment advice as per Article 52 of the MiFID 1 Implementing Directive. We are not particularly concerned about the potential ambiguity which ESMA has highlighted and would stress that, according to the original definition, distribution channels refers to information which “is, or is likely to become, publicly available, i.e. accessible to a large number of persons”. This is unlikely to be the case in ESMA’s example of email correspondence used to provide personal recommendations to a specific person (which we agree should not be exempted from the investment advice provisions).

We note that internet and web-based applications, mail and other distribution channels are an increasingly important way to distribute general recommendations and such communications should not be interpreted as investment advice. ESMA should focus on the nature of the recommendation rather than the channel used to provide it. Where advice is widely disseminated with no indication that the recommendation is personal, then it should not be considered a personal recommendation

Rather than simply removing the references to distribution channels we would suggest amending the text as follows:

*“A recommendation is not a personal recommendation if it is issued exclusively to the public or [widely circulated] through distribution channels provided that it is a general recommendation*



*within the meaning of Annex 1 Section B (5) of Directive 2014/65/EU on the basis that is neither based on an evaluation of the personal circumstances of a particular person nor presented or apparently presented as suitable for any particular person.”*

<ESMA\_QUESTION\_2>

### **2.3. Compliance function**

**Q3: Do you agree that the existing compliance requirements included in Article 6 of the MiFID Implementing Directive should be expanded?**

<ESMA\_QUESTION\_3>

#### AFME Response

No, we do not agree fully – please see our comments below. On a general note, whilst we broadly support the principles of the ESMA MiFID 1 Guidelines, we would question whether this level of detail is actually appropriate for inclusion in Level 2. We would also note that, throughout, the advice could benefit from a clearer articulation of the three lines of defence model as expressed in the EBA Guidelines on Internal Governance.

We are not aware of major issues with the operation of the Compliance function under MiFID 1 and would therefore suggest that ESMA should preserve the current Guidelines as they are and reduce the level of detail and prescriptiveness in the draft technical advice. As MiFID 1 and the current ESMA MiFID 1 Guidelines are part of the provisions that allow European firms to evidence substituted compliance under the Dodd-Frank requirements, it is important that the impact of any changes in the overall framework will be carefully considered.

The ESMA advice should stress that overall responsibility for compliance with applicable rules and regulations rests with the management body which also has the responsibility for establishing the Compliance function. With regard to a requirement for a permanent Compliance function, we support the advice which appears in line with practice in many firms. However, it is important that the advice is applied flexibly and allows for appropriate outsourcing/ contingency arrangements and involvement of other control functions. Furthermore the technical advice should explicitly recognise that it is legitimate for the Compliance function to rely on other parties such as internal and external auditors, internal and external counsel, etc. in meeting its obligations. For example, it would be common for a firm’s internal audit function to regularly review adherence to the CASS obligations.

We agree that Compliance should be independent of the business and that the senior Compliance officer should be appointed and replaced by the management body or supervisory function. In order to ensure the independence of the Compliance function it should be limited to providing advice to the first line business functions in relation to carrying out investment services and Compliance should not be expected to assist in carrying out investment services.

We also support, in principle at least, annual reporting of compliance risks and issues but believe that this should be interpreted flexibly so that there is no requirement to create additional reports or new templates as long as the senior management body already receives the required information as part of an overall risk reporting framework. We believe that the requirement stating that reports to management should cover the “*implementation and effectiveness of the overall control environment*” is too broad and vague. ESMA should explicitly acknowledge that there are other risk and control functions (e.g. operational risk, credit risk, market risk) which

should be required to report to the management body on their aspect of the overall control environment. Compliance should not be responsible for this reporting.

Similarly, it is good practice for firms to carefully monitor complaints and involve Compliance in the oversight process but this must be applied proportionately and in the context of the Compliance resource available. Given the importance for flexibility, these requirements would better covered in Guidelines rather than an Implementing Directive.

Regarding the new requirement for a compliance risk assessment, the proposal would appear in line with practice in most AFME member firms and we welcome the focus on a risk-based approach. To ensure the efficient use of resources it will be important to apply the requirement proportionately and in a way that is relevant to the firm's risk profile, customer base and product range, with the main emphasis being on areas where compliance risk is most significant. We also agree that the compliance risk assessment should drive the compliance monitoring programme (CMP) which will review specific areas of the business based on the results of the risk-based compliance risk assessment. We are, however, concerned about the suggestion in paragraph 4 that the CMP should take into account "*all areas of the investment firm's investment services*". This would seem to imply that the CMP should cover all areas of business rather than those identified on risk-based criteria thus implicitly calling into question the value of performing a compliance risk assessment in the first place.

With regard to the new requirement for Compliance to escalate significant failings to the management body, we support this in principle but would suggest that firms should be able to exercise a degree of discretion and use this only after existing internal reporting mechanisms (e.g. to the CEO, Chief Risk Officer, General Counsel or Senior Business Management) have been exhausted. Whilst a compliance matter may be of relevance to a particular member of senior management, it would not always necessarily warrant escalation to the full management body. Only reports highlighting material risks in the opinion of senior Compliance management should require referral to a compliance/risk/internal audit committee of the Board (whichever would receive the annual compliance assessment report).

<ESMA\_QUESTION\_3>

**Q4: Are there any other areas of the Level 2 requirements concerning the compliance function that you consider should be updated, improved or revised?**

<ESMA\_QUESTION\_4>

#### AFME Response

Yes. We believe the requirements, whilst broadly sensible, are too detailed and granular. Bearing in mind the above, however, the advice could potentially be enhanced by making specific reference to the need for effective recording, escalation and resolution of the findings from the monitoring programme.

<ESMA\_QUESTION\_4>

## **2.4. Complaints-handling**

**Q5: Do you already have in place arrangements that comply with the requirements set out in the draft technical advice set out above?**

<ESMA\_QUESTION\_5>

## AFME Response

No – we believe this would not be appropriate or practical in all instances. Most AFME members already have extensive complaints handling procedures in place which are in line with the regulatory requirements in the relevant member states. We are, however, concerned that ESMA seeks to extend the obligation for a complaints management policy to ‘potential clients’. Overall we believe that a firm’s primary responsibility is towards its actual clients with any other requirements being very limited, if applicable at all.

Whilst we agree that effective and fair complaints handling is important for all client categories, we believe that complaints handling procedures should be applied proportionately taking into account the nature of the client (retail vs professional) and recognising the very different types of complaints across the categories of clients. For example, in the professional or wholesale elements of the market, customers and counterparties are much more likely to have access to legal advice, be it in-house or external, should they be dissatisfied with the service provided. Furthermore, such customers and counterparties are much more likely than retail customers to take court action against a service provider should there be a dispute. Additionally, it is often the case that professional customers or eligible counterparties have access to similar information as the financial services provider and thus one of the fundamental weaknesses inherent in the retail sector, namely information asymmetry, is not present or is largely eliminated in the professional sectors. Finally, it is often the case in the professional sectors that customers and counterparties will purchase financial services from a multiplicity of providers, not least in order to encourage the providers to offer better service or better prices than their competitors. The threat of withdrawing business, in such cases or in the event of a dispute, is a more powerful incentive to manage complaints properly in this element of the market than the threat of an individual customer transferring his/her business to a competitor in the retail market.

For professional clients a clear distinction needs to be made between complaints and commercial discussions in the normal course of business. In order to make this distinction clear (and for the ESMA requirements to apply), professional clients should be required to register a formal complaint in accordance with the firm’s established complaints policy and procedures.

It is unclear what ‘endorsement’ of the complaints management policy by the firm’s management body requires in practice. Whilst we support transparency with regards to complaints handling processes, it should be noted that the provision of general information should allow for differences according to client segmentation.

We do not believe that in all instances a separate and/or central complaints management function should be required as for example many complaints can be resolved at the first customer point of contact. We also believe that in line with the three lines of defence model, operational oversight of the complaints handling process should sit with business functions in the first instance, with Compliance given access to the information/opportunity to engage in the process but no mandatory obligation placed on Compliance. Whilst Compliance should consider complaints as a source of relevant information of its general monitoring responsibilities, the analysis of complaints and complaints handling data should typically be performed by the first line business functions which hold the client relationship and are therefore best placed to undertake this role. This also ties in the ESMA advice on the Compliance function (section 2.3) which suggests that Compliance should “oversee” rather than manage the operations of the complaints-handling process. We would suggest rewording as follows: *“Investment firms should establish a complaints management process which enables complaints to be investigated. Oversight of this process may be carried out by control functions such as Compliance or Legal.”*

We have concerns regarding the requirement to provide the client with options to refer the complaint to an Alternative Dispute Resolution (ADR) entity or take civil action. In particular we



would suggest that ESMA should carefully review interaction with the Directive 2013/11 on alternative dispute resolution for consumer disputes.

<ESMA\_QUESTION\_5>

## **2.5. Record-keeping (other than recording of telephone conversations or other electronic communications)**

**Q6: Do you consider that additional records should be mentioned in the minimum list proposed in the table in the draft technical advice above? Please list any additional records that could be added to the minimum list for the purposes of MiFID II, MiFIR, MAD or MAR.**

<ESMA\_QUESTION\_6>

### AFME Response

No. The list of records appears broadly appropriate and we do not believe that any other additional records are required. By way of general comment, we support, in principle, a harmonised list of records but we are concerned by the ability of member states to impose additional and potentially significant requirements. This creates an uneven playing field and makes it more difficult to undertake business on a cross-border basis. We believe that there should be a degree of flexibility for both firms and NCAs in what is required to demonstrate compliance with the MiFID obligations.

Additional records to the list would be disproportionate. We would welcome if ESMA could suggest a risk based approach and allow firms discretion to implement a proportionate record keeping system. We further suggest that the requirement outlined in the table should be subject to a full cost and benefit analysis as it will mean a significant cost to maintain the relevant order data for firms. With regard to the table of records in point 7 of the technical advice for Professional clients, financial institutions should have the flexibility to define general categories and procedures of products/services that are suitable and appropriate as opposed to specific product by product/service.

In general, however, we are concerned by the potential for duplication, given that firms will be required to publish data as a result of other regulatory requirements. For example, firms will already be required to publish data on client orders when operating as Systematic Internalisers (SIs).

For the avoidance of doubt we would also suggest that references to “in writing” should be replaced by “in writing or other durable medium” given that many policies or documents are now stored electronically rather than in written/paper form. However, it is important that ESMA (and national regulators post MiFID implementation) are cognisant of the fact that an electronic format will not be appropriate in a number of instances, and firms will need significant flexibility in determining which nature and volume of records will warrant storage in an electronic format.

We also suggest that it would be helpful if ESMA could clarify that the requirement for records to be held in electronic format (where the nature and volume of records warrants such a format) will only apply to records created after MiFID 2 coming into force (January 2017) rather than on a retrospective basis.

<ESMA\_QUESTION\_6>



**Q7: What, if any, additional costs and/or benefits do you envisage arising from the proposed approach? Please quantify and provide details.**

<ESMA\_QUESTION\_7>

#### AFME Response

See our response above. Our members have advised that significant and disproportionate additional IT and technical costs are likely to arise from the mandatory requirement regarding cancellation and modification of orders. Furthermore, given the significantly broadened scope of the SI regime under MiFID2, additional costs are likely to arise from the obligation to record prices quoted by Systematic Internalisers. We believe that there should be scope for firms to follow a risk-based approach providing some discretion to implement a proportionate record keeping system.

<ESMA\_QUESTION\_7>

## **2.6. Recording of telephone conversations and electronic communications**

**Q8: What additional measure(s) could firms implement to reduce the risk of non-compliance with the rules in relation to telephone recording and electronic communications?**

<ESMA\_QUESTION\_8>

#### General AFME comments

It will be impracticable to separate out internal calls that need to be recorded to comply with MiFID 2 from those that do not. It is unlikely that any material number of internal calls will, in fact, need to be recorded to comply with MiFID 2. Therefore, we believe that the idea of extending the requirements to include the recording of internal as well as external calls is too onerous and costly as firms will end up keeping records of very large numbers of irrelevant phone calls.

We are concerned that, without providing any rationale or explanation, ESMA has chosen to overturn CESR's 2010 advice which made it clear that internal calls should not be captured. Given the significant impact of such proposal and the need for firms to obtain clarity on the scope of the proposals, we would suggest that this topic should not be covered at Level 2 but given further consideration at Level 3 through ESMA Technical Guidelines and Recommendations.

Paragraph 9 of the draft technical advice should be amended to ensure that only those face-to-face meetings which form part of the process of reception and transmission of orders, execution of orders on behalf of clients and dealing on own account, need to be recorded.

Furthermore, we believe that ESMA should clarify that the records that must be provided to clients 'upon request' are limited to those records that relate to the business conducted with the investment firm.

As regards the requirements to record and store telephone conversations as contemplated by MiFID 2 it will be necessary to ensure that all such requirements (including any technical advice) are consistent with EU data protection laws, ECJ rulings and any Member State's national civil or criminal law prohibiting or restricting the recording or storing of certain telephone conversations. Firms cannot be expected to have to make decisions themselves as to which laws or regulations prevail in case of conflicts between them; that is a matter for legislators.

### AFME Response

The measures proposed appear adequate and indeed excessive in some areas as outlined in our response. Therefore we do not propose any additional measures.

<ESMA\_QUESTION\_8>

### **Q9: Do you agree that firms should periodically monitor records to ensure compliance with the recording requirement and wider regulatory requirements?**

<ESMA\_QUESTION\_9>

### AFME Response

No, we do not agree with ESMA's advice as currently drafted. Of course firms need to monitor the effectiveness of the arrangements that they have in place to comply with the rules, but the current drafting of paragraph 7 introduces, we think unintentionally, a requirement that is far too broad. A firm will, as part of its ongoing monitoring obligations, review trades and communication records as far as legally permitted. Any monitoring obligations should be proportionate and appropriate to the size and organisation of the firm, and the nature, scale complexity and risk profile of the relevant business or product. Therefore we would either suggest deleting the second sentence of paragraph 2 or replacing it with the following wording:

*“Investment firms should have in place requirements to seek to ensure compliance with the recording and record-keeping requirements in accordance with Article 16(7) and Recital 57 of MiFID II ~~and their wider regulatory requirements~~. The firm shall periodically monitor an appropriate sample of the records of all transactions and orders subject to these requirements, including relevant conversations, to monitor compliance with the ~~regulatory~~ record-keeping requirements.”*

We also note that it may be possible for an investment firm to check the control framework and processes that are in place to allow a firm to comply with the relevant requirements without monitoring the records (or samples thereof) themselves.

<ESMA\_QUESTION\_9>

### **Q10: Should any additional items of information be included as a minimum in meeting minutes or notes where relevant face-to-face conversations take place with clients?**

<ESMA\_QUESTION\_10>

### AFME Response

No, we do not believe that additional items should be included. Whilst we agree that the detail of the order itself needs to be recorded, there appears to be no rationale for requiring information on face-to-face meetings which is more detailed than the equivalent telephone record or electronic communication. Additional items of input should be at the firm's discretion. We also believe that there should be some discretion in how these notes are captured and note that it may not be possible in all circumstances to identify the initiator of the meeting nor all attendees. Notes should be capable of being recorded in writing or any other durable medium. So we would change the wording as follows:

#### *Face-to-face conversations*

*9. Investment firms shall record in ~~written~~ minutes or notes in writing or other durable medium ~~all~~ relevant information related to relevant face-to-face conversations with clients. The*



information recorded is at the discretion of the firm but ~~must~~ may include ~~at least the following~~, to the extent known:

- i. date of meeting;
- ii. location of meeting;
- iii. identity of the attendees;
- iv. ~~initiator of the meeting~~; and
- v. other relevant information about the transaction.

<ESMA\_QUESTION\_10>

**Q11: Should clients be required to sign these minutes or notes?**

<ESMA\_QUESTION\_11>

AFME Response

No - clients should not be required to sign the minutes/notes and this must be a matter for firms' discretion. Whilst we agree that it is good practice to ensure that clients are comfortable that the salient facts have been captured appropriately, we do not believe that having them sign the minutes/notes should be mandatory. We believe that the ESMA advice should make it explicit that an internal note on orders received and transmitted and the execution of orders should be sufficient. Also given that the documentation is not a requirement for the legal validity of the transaction as such, we are concerned that introducing a requirement for a signature could confuse clients regarding the legal status of transactions. From a practical point of view, the majority of client transactions take place via telephone, email and other non-face-to-face media.

Furthermore, it is unlikely that minutes could be produced at the same time as any face to face meeting with the client. This means that in the vast majority of cases, minutes would have to be sent to the client by post or other means with a request to be signed and returned. Client inertia is likely to result in a very low return rate thus causing a very large volume of follow-up work to be undertaken by firms. Such issues would even be further exacerbated in instances where there is frequent and ongoing engagement between advisers and clients and/or where the client resides in a different country.

<ESMA\_QUESTION\_11>

**Q12: Do you agree with the proposals for storage and retention set out in the above draft technical advice?**

<ESMA\_QUESTION\_12>

AFME Response

No, we do not agree. We think 5 years is already too long (but prescribed at Level 1) and we are concerned that a generic provision to potentially extend to 7 years will inexorably become the standard which we do not believe to be necessary. We understand that the extension to 7 years may be envisaged to apply in specific and exceptional circumstances where a firm has been notified by their competent authority of the specific records to be kept for a longer period. If this is the intention, we would urge ESMA to clarify this in its advice. We also question whether it is technically possible to retain records in a format which, with ever improving technology, does not allow the original record to be altered or deleted. Instead, it would be feasible to employ technology which allows investigators to track the changes made.

We believe that ESMA should provide further guidance/advice regarding the requirement that records of telephone conversations shall be provided to the client on request. ESMA should clarify that such requirements only relate to client's investment business with the firm and that the firm should be required to undertake "reasonable efforts" to locate and provide such records as it can sometimes be very difficult and costly to locate specific conversations over a long period of time.

<ESMA\_QUESTION\_12>

**Q13: More generally, what additional costs, impacts and/or benefits do you envisage as a result of the requirements set out in the entire draft technical advice above?**

<ESMA\_QUESTION\_13>

#### AFME Response

Direct costs will relate to the upgrading or development and introduction of new systems or system capabilities. There will be additional costs for introducing different types of telephones and associated costs related to employee training. Resources required to monitor records for transactions will increase significantly, particularly for large firms with a large number of client facing staff. Other costs will include storage capabilities as the retention period is extended significantly. These records will also need regular maintenance, testing and back-up.

In the case of requests for specific records (either from clients or NCAs), there will also be significant staff costs in order to locate and retrieve the information, search for relevant conversations, analyse and transcribe the information etc. This will be exacerbated by the 5-year retention period which represents a significant increase in retention period in a number of countries such as Germany or the UK.

We are also concerned about the potential costs arising from the Level 1 requirement that records should be made available to clients upon request and would suggest that this should be limited to those records that relate to the business conducted with the investment firm.

In addition, the legal uncertainties outlined in the preceding questions will increase operational and legal risk.

As regards the requirements to record and store telephone conversations as contemplated by MiFID 2 it will be necessary to ensure that all such requirements (including any technical advice) are consistent with EU data protection laws, ECJ rulings and any Member State's national civil or criminal law prohibiting or restricting the recording or storing of certain telephone conversations. Firms cannot be expected to have to make decisions themselves as to which laws or regulations prevail in case of conflicts between them; that is a matter for legislators.

<ESMA\_QUESTION\_13>

## **2.7. Product governance**

**Q14: Should the proposed distributor requirements apply in the case of distribution of products (e.g. shares and bonds as well as over-the-counter (OTC) products) available on the primary market or should they also apply to distribution of products on the secondary market (e.g. freely tradable shares and bonds)? Please state the reason for your answer.**

<ESMA\_QUESTION\_14>

### General AFME comments (referring to Questions 14-19)

Whilst we do not agree with ESMA's advice in many aspects, we welcome ESMA's commitment that the measures are to be applied in an 'appropriate and proportionate manner'.

However, we note that in ESMA's draft technical advice in relation to product governance under paragraph 16 (Product Governance Obligations for Distributors) states "The obligations for distributors should apply to investment firms when deciding the range of products (issued by itself or other investment firms) and services.....". References to "services" are also included in paragraphs 17 and 18. It is not clear how the provisions relating to product governance apply to "services" and for many provisions it would be impractical to do so. Including services seems to go beyond ESMA's remit in Level 1 as this section should only be dealing with product governance provisions and, therefore, we would suggest removing the reference to "services" in these paragraphs.

We welcome the fact that ESMA acknowledges differing obligations and overlap between distribution models. However, we believe that the advice needs to distinguish more clearly between models where manufacturers operate on a reverse enquiry basis (following a distributor request for quote), those where manufacturers design and come up with the product (to be distributed), and situations where banks are a mere hedge provider. For example, in the proposals for manufacturers to periodically review instruments offered or marketed (paragraph 12), including taking into account events that materially affect the potential risk to the identified target market, the responsibility for this may vary depending on the model. We therefore believe that relevant obligations should be tailored to the particular manufacturer model.

We note that there is significant uncertainty regarding the definition of "manufacturer" given that neither the Directive nor the proposed implementing measures have provided a precise definition so far. For example, we note that there is no specific definition of "manufacturer" in Article 4 of MiFID 2 and the Consultation Paper merely states that investment firms manufacturing investment products are "...those firms that create, develop and design investment products".

The ESMA opinion on "Structured Retail Products - Good practices for product governance arrangements" (ref. ESMA/2014/332) sets out a broader and inter-sectoral definition of "manufacturer" which refers to any natural or legal person that is responsible for the development and issuance of a structured retail product (SRP) or any natural or legal person that makes changes to, or combines, such products. It is specified that "...in practice, within the supply chain for an SRP, the manufacturer is the first link: i.e. it is the firm that creates and produces the SRP. A manufacturer often also 'designs', 'originates', 'engineers', 'packages' or 'structures' a product so that the distributor can sell it effectively". We also note that on 28 November 2013 the Joint Committee of the ESAs published eight high-level principles applicable to financial institutions' internal product oversight and governance processes, regardless of the sector the product belongs to (banking, securities, and insurance). In this paper the manufacturer is defined as "any natural or legal person that is responsible for the development and issuance of a product or any natural or legal person that makes changes to, or combines, products, provided that the natural or legal person is, for the purpose of its manufacturing activity, subject to regulation under Union sectoral legislation within the scopes of action of one or more of the ESAs".

In light of the above, we would suggest that ESMA should define the role of manufacturer by taking into consideration the different activities that the 'MiFID players' are allowed to carry out. In our view, these are the main features to be taken into account:

- a) given the MiFID II scope, the definition cannot be inter-sectoral. This means that:

- only investment firms and credit institutions can be considered
- only financial instruments can be considered (since structured deposits are not included either in Art. 16 or in art. 24 of MiFID II)
- b) manufacturers can be investment firms/credit institutions whose formalized role is to
  - issue/produce financial instruments (e.g. bonds)
  - create/design/originate financial instruments – i.e. when they lead on the project of a financial instrument which may also be issued, developed or structured by means of other firms
  - develop financial instruments – i.e. when they undertake part of the project relating to a financial instrument which is issued by another firm
  - combine/engineer/package financial instruments – i.e. when they act as wrappers or structurers
  - change financial instruments – i.e. when they alter the risk-reward profile of an existing financial instrument
- c) different manufacturing roles may entail different arrangements and organizational steps in the product governance policy to be set and implemented up by manufacturers themselves.

#### Specific comments on Advice:

With regard paragraphs 2 and 3, regarding conflicts management for manufacturers, the obligation should be to provide products which are suitable for the customers and which meet the customers' needs and objectives. The relative position of the investment firm should not be relevant and it is perfectly possible and sensible for customers to have different views or outlook (or objectives) from the product manufacturer. Genuine conflicts of interest should not be confused with market positioning. Furthermore conflicts of interest should be identified as part of the original product approval, not each time a product is generated.

We note that the proposed wording regarding the target market suitability requirement (paragraph 7), does not differentiate between types of clients, i.e. it applies when products are being sold to professionals where knowledge and experience can be assumed (subject to this being confirmed by ESMA – see our comments on Q86). Rather than identifying groups of investors with whose needs the product is not compatible, the advice should clarify that the product should not be sold to groups for whom it was not intended or designed.

Paragraph 8 requires that the target market must be 'specified' at a sufficiently granular level. Whilst we do not object to this requirement, it is unclear how such specification should be documented. It is important that this requirement is interpreted flexibly and that any duplicative and prescriptive documentation requirements are avoided.

The requirement for manufacturers to undertake scenario analysis (paragraph 9), is likely to be difficult for reverse enquiries. We note that there are very specific aspects to consider (e.g. commercial viability, market environment deterioration, firm financial deterioration, high demand putting a strain on firm resources/ product dynamics, counterparty risk materialises) and significant flexibility would be required for firms. We also note that the use of scenario analysis and in particular the scenarios highlighted in 9 are generally only relevant for more complex, proprietary based products where there are multiple market forces which could impact performance and/or there is ongoing reliance on a party to perform a service. For the vast majority of repeat simple products it is not clear what the purpose of the scenario analysis is.

Most structured products have a defined outcome depending on the performance of a reference asset so any stress to the performance of the asset will simply determine the outcome. Back testing can be used to assess the performance of a product historically but this has only limited value and would simply be used by an investment firm to flag any products that have historically been higher risk. Overall we believe that significant flexibility is required and firms should only have to perform a scenario analysis “*where it is appropriate and possible to provide a scenario*”.

With regard to paragraph 10, which requires investment firms to consider the charging structure proposed for the product, we note that Structured products, unlike funds, will pay out a fixed amount at maturity dependent on factors that are pre-determined and disclosed in the product terms upfront. The price of the product is clear upfront and all distribution fees must be disclosed already. It is therefore not in all circumstances clear what this proposal actually requires the investment firm to do. We are aware that the US and German markets have opted for an “issuer estimated value” disclosure as part of the prospectus to ensure transparency but it is not clear if this is related to the ESMA proposals. It is important to focus on the disclosure of key information which adds actual value. Imposing unnecessary additional information requirements will overburden end consumers with complex and potentially irrelevant documents which will not help them better understand the risk but which will cost a lot to produce. It is also not clear how this disclosure would take place – presumably through KIDs. Providing detail on this process may actually have a negative effect if the distributor relies on the manufacturer’s assessment process (or vice versa) rather than assessments being independent. Finally we note that it is unclear how this requirement would apply to the majority of structured product business where the distributor defines the product terms and the target market and requests pricing from a number of investment firms.

The requirement in paragraph 13 to review investment products “prior to any further issue or re-launch” is too prescriptive and would not always work effectively. For example, there are a number of products traded on a ‘flow basis’ which are less complex and suitable for all investor types where this requirement may not be as relevant. The business should be able to trade these with standing approvals (these would be regulated by new product due diligence processes) rather than approvals being documented for repeat issuance. Proposals need to focus on perceived potential market failures rather than being too wide ranging.

We are not clear what the provisions in paragraph 14 will mean in practice as many products are sold with barriers/thresholds which form a fundamental part of the product performance on the risk taken by the investor. Proximity to these barriers will change daily but ultimately these are pre-set contractual terms and it is not clear what action ESMA would expect firms to take. We have similar concerns regarding Article 15.

Overall, we believe that some of the requirements on distributors create uncertainty as to where the obligations apply between manufacturer and distributor. However, we welcome some of the obligations placed on distributors as well (e.g. to impose obligations on them to request the necessary information and to require provision of information to the distributor, but the provisions need to go wider (to take into account the reverse enquiry model outlined above). It should also be noted that this only works for an EU distributor model (the reverse is envisaged - with non-EU product manufacturing, but not non-EU Distribution). It is also important to note that distributor requirements should only related to actively marketed products.

Whilst we broadly agree with strengthening the duties of the Compliance function, the proposals need to be careful not to misplace first line of defence requirements and impose them on the second line of defence, i.e. Compliance. Compliance is generally responsible for policies but business needs to be responsible for ‘measures’ and actual compliance with Compliance supporting, monitoring and escalating where required. The suggested obligations in paragraphs 5 and 24, for example, on compliance to include in its board reporting information about the



investment products and services offered by the firm should be placed on the business heads not on Compliance.

With regard to the requirements for the Board of Directors/ governing body requirements, it should be made clear that whilst the Board of Directors are responsible for oversight, they would not expect to have day to day involvement in detail, but to be aware of failures/exceptions and consider matters escalated to them and take appropriate action.

#### AFME Response

No - we do not agree with either option. In fact we do not understand the rationale for this question and would seek clarification from ESMA as to why such extension of requirements is being considered. The question appears to misunderstand the process and scope of distribution as opposed to secondary market trading. Secondary market products are fundamentally different from primary market products and it would be difficult to see how these requirements could ever be applied to secondary markets.

Appropriate investor protection provisions for sales on the secondary market are already provided by the suitability and appropriateness provisions within MiFID as well as regulations such as the Prospectus Directive, PRIIPS (once in force) and UCITS. It is unclear how the distributor requirements would interact with these requirements and the primary market requirements would risk being duplicated by large numbers of secondary market distributors which would be difficult to enforce and complicated to implement for limited additional policy benefit/consumer protection compared with the existing MiFID protections and the requirements on primary market distributors.

Furthermore, imposing distribution obligations on secondary market trading would have a significant negative impact on liquidity and could inhibit exit opportunities for investors in some products to the investors' detriment

The question also implies that the product governance requirements are extended to shares and bonds, whether issued in the primary market or traded in the secondary market. We believe shares and bonds should be excluded in their entirety from the product governance rules. Such investments are not “manufactured” by relevant issuers and are not designed with identified target markets in mind; principally, they are means by which corporates raise capital from investors in accordance with relevant public offering or private placement rules, not investment products manufactured for distribution. As such products are non-complex in nature, with distribution channels regulated under existing public offering/private placement rules (such as the EU Prospectus Directive) and applicable suitability/appropriateness requirements, it is disproportionate to apply product governance requirements in addition to such regulatory regimes. In particular, it is difficult to see how target market analyses can be applied sensibly to shares and bonds – for example, non-MiFID issuers would not be required to provide target market analyses to MiFID distributors and there are risks involved with MiFID distributors trying to interpret a target market for a share/bond issuance on behalf of a non-MiFID issuer with which it has no distribution arrangement. It is also not clear whether a target market analysis would provide additional meaningful controls above and beyond the restrictions and requirements placed on the public offering of such investments under the Prospectus Directive (particularly requirements imposed on broader public offering of securities to retail clients).

In this regard, it may be useful to draw an analogy with the proposed EU regulation on key investor documents for packaged retail investment products (“PRIIPs”). As PRIIPs are investment products that are broadly described as being manufactured or structured for distribution to





investors and it is likely that firms would bear in mind relevant target markets for PRIIPs when producing the relevant investor documents. We suggest that consistency between the two regulatory initiatives is desirable given the common investor protection objectives of ensuring effective product governance, distribution and client information needs in respect of investment products that are truly manufactured or structured by firms. As such, ESMA is encouraged to look at whether MiFID product governance arrangements should be aligned with the PRIIPs initiative in terms of product scope and exclude certain “non-manufactured” products such as shares, bonds and non-structured deposits from the scope of the product governance rules.

<ESMA\_QUESTION\_14>

**Q15: When products are manufactured by non-MiFID firms or third country firms and public information is not available, should there be a requirement for a written agreement under which the manufacturer must provide all relevant product information to the distributor?**

<ESMA\_QUESTION\_15>

#### AFME Response

We agree in principle with ESMA’s objective of enhancing investor protection which this requirement is seeking to fulfil. In some instances, such a new requirement may assist an EEA distributor in justifying particular requirements and contractual terms. In order to reduce the risks of mis-selling it is important that distributors understand the products they plan to distribute and this could for example include a written confirmation by the manufacturer that it has provided the distributor with the relevant information. However, we note that the requirement for a written agreement would only be binding on the EEA MiFID firm and there is a potential for push-back from non-MiFID firms creating potentially an unlevel playing field. Therefore, we think it would be better to leave this to commercial forces rather than mandate a requirement for a written contract under regulation. It should be left up to the EEA Distributor and Non-EEA Manufacturer to effectively manage their relationship and their respective obligations.

We also note that the term ‘collaborate’ in paragraph 6 of the advice is unclear and should be clarified in the context of this question.

<ESMA\_QUESTION\_15>

**Q16: Do you think it would be useful to require distributors to periodically inform the manufacturer about their experience with the product? If yes, in what circumstances and what specific information could be provided by the distributor?**

<ESMA\_QUESTION\_16>

#### AFME Response

Feedback from our members indicates that there is already regular dialogue between most distributors and manufacturers. In this context, ESMA’s reference to “experience with the product” appears very vague. We also note that non-EEA distributors would not be bound by such a requirement and may reject such requests by manufacturers.

Overall, we believe that it would be difficult to prescribe a standard requirement. In practical terms, the information may be relevant if a distributor is aiming to win new business, but the usefulness of this requirement may depend on sanctions available to the manufacturer. As stated above, knowledge would ordinarily be shared anyway for commercial purposes and it would, therefore, be better to leave this to commercial forces to determine. However, a requirement on distributors to explicitly disclose any complaints and/or mis-selling claims would be valuable as



well as providing reasonable high-level management information on a periodic basis, and we would suggest that ESMA should consider this as this would also aid investor protection (although it needs to be mindful of a distributor's obligations of client confidentiality).

<ESMA\_QUESTION\_16>

**Q17: What appropriate action do you think manufacturers can take if they become aware that products are not sold as envisaged (e.g. if the product is being widely sold to clients outside of the product's target market)?**

<ESMA\_QUESTION\_17>

#### AFME Response

Generally, and in the particular context of certain product governance frameworks, most manufacturers would already have in place a process for regular review of key risk indicators ("red flag process") which amongst other things provides evidence that products are potentially not being sold as intended. Current practice is that the manufacturer could - depending on the outcome of such monitoring - undertake a number of actions, including: i) reviewing the manufacturer/distributor relationship and/or undertaking commercial sanctions (restricting or prohibiting dealings with the counterparty); ii) contractual sanctions negotiated between the parties; iii) regulatory escalation. Most typically, if there are any outstanding red flag issues manufacturers would not enter into new product issuance agreements with the distributor.

With regard to iii) if a manufacturer or distributor becomes aware of a breach of regulatory requirements or principles then it will typically be subject to an obligation to report it to the regulator. Otherwise, appropriate action that a manufacturer can take should not be subject to law or regulation. As noted above, remedies should be limited to contractual remedies under the distribution agreement it has in place with the relevant distributor.

In addition, a manufacturer should be able to impose controls so that a product is only promoted to the target audience. In particular, the manufacturer should be able to place additional restrictions on the products by tailoring the product literature, disclaimers, access etc. It would also be important for a manufacturer to impose contractual obligations on the distributor. For example, the manufacturer should be able to impose obligations to report periodically on an anonymised basis on the profile of purchasing customers of the distributor and then build this into the relationship meetings between the parties.

Furthermore in the context of portfolio management or investment advice, the regulatory frameworks need to take into consideration the fact that a single investment may not fall within the target market but at a portfolio level, the client's best interests have been met.

<ESMA\_QUESTION\_17>

**Q18: What appropriate action do you think distributors can take, if they become aware of any event that could materially affect the potential risk to the identified target market (e.g. if the distributor has mis-judged the target market for a specific product)?**

<ESMA\_QUESTION\_18>

#### AFME Response

It is important that there is sufficient flexibility regarding the actions a distributor can take. It is also important to bear in mind that it is equally possible that the manufacturer has misjudged the intended target market.

The key reasons for products not being suitable for the target market could include a) mis-selling and b) flaws in the product design. Overall, the distributor should assess whether to stop further

distribution and assess the matter with the manufacturer. In addition to potential changes to the sales process and product design, the distributor may also need to consider client impact including restitution issues. Other steps could include: (1) to the extent possible, informing the investors of the event (i.e. if they have an ongoing relationship with them); (2) facilitating the secondary market so investors are able to exit the product, (3) reconsidering the target market and product governance arrangements.

However, the specific actions that might need to be taken will always depend on the circumstances and should not be prescribed in advance.

<ESMA\_QUESTION\_18>

**Q19: Do you consider that there is sufficient clarity regarding the requirements of investment firms when acting as manufacturers, distributors or both? If not, please provide details of how such requirements should interact with each other.**

<ESMA\_QUESTION\_19>

#### AFME Response

No, at present there is not enough clarity in either MiFID 2 or the ESMA consultation paper to establish how the target market of clients for each product should be determined and this creates a high level of legal uncertainty for both manufacturers and distributors.

We welcome the fact that ESMA acknowledges differing obligations and overlap between distribution models. However, we believe that the advice could be enhanced by distinguishing more clearly between models where manufacturers operate on a reverse enquiry basis (following a distributor request for quote), from those where manufacturers design and come up with the concept (to be distributed). See also our general comments.

We also believe that the draft technical guidance also lacks clarity on (i) requirements imposed on distributors and (ii) the interaction between manufacturers and distributors, especially where only one party is subject to MiFID 2 (as e.g, the other party is a non-EEA entity).

With regard to requirements imposed on distributors, the MiFID 2 requirements make clear that the distributors are required to “obtain” target market information produced by manufacturers and to “understand the characteristics and identified target market of each financial instrument” (see Article 16(3) of MiFID 2). However, the draft technical guidance can be read as going beyond this and imposing an obligation on distributors to undertake a target market analysis in addition to the analysis undertaken by manufacturers (see footnote 34 on Page 49 of the Consultation Paper).

Notwithstanding the potential conflict between the Level 1 text and the draft technical guidance, we envisage difficulties if distributors are required to undertake a target market analysis for the products they distribute that the draft technical guidance does not currently address. For example, there is no guidance on what the outcome should be if a distributor’s target market analysis differs from a manufacturer’s, does one analysis take precedence in that scenario? Can a distributor recommend products based on their target market analysis if it differs from a manufacturer’s analysis (see our response to Question 17 for our views on this)? Also, more fundamentally, there is a question as to whether a distributor is the most appropriate firm/person to dictate the properties of a target market of a product manufactured by a third party. These are all matters that need to be further discussed and clarified as they are critical to ensuring that there is clear division of regulatory responsibilities between manufacturers and distributors.

We also note ESMA’s comments that a "potential target market" shall be determined on a "theoretical basis" due to the absence of a direct relationship with clients. However, it is also

stated that the Target Market shall be specified "at a sufficiently granular level". This, and the reference in the Consultation Paper to factors to be considered by distributors, i.e. risks, costs and complexity (No. 17, 25, 26, pg. 47), which are the same as those considered in a suitability test, leads to more, not less uncertainty.

Further clarity is also required regarding the interaction between product governance requirements and suitability/appropriateness duties. As stated in the ESMA opinion on structured retail products (ESMA/2014/332) the target market determination should not be mixed with the suitability requirements.

There is a potential conflict between both requirements – for example, an investment adviser may feel constrained from recommending a product for which it does not have sufficient target market information (e.g. products created by a non-MiFID manufacturer), even though the product may be more suitable for the client than another product on which it does have target market information. If a distributor is required to only distribute products for which it has sufficient target market information, this is likely to lead to less choice of investment products for clients (especially for products manufactured by non-MiFID manufacturers) and potential risks to EU distributors' competitiveness in the market. As such, we recommend further focus and guidance on circumstances where distributors can adapt sales processes where insufficient target market information is available to a distributor (as envisaged by Paragraph 15(i) on Page 44-45 of the Consultation Paper, which is not yet reflected in the draft technical guidance).

The proposed requirement on distributors to review the investment products they "provide", "offer" or "market" should also be clarified. The words "provide", "offer" and "market" are different and so should not be used interchangeably in the technical advice. As suggested in 2.14 (20) of the Consultation Paper, "marketing" should not occur where a firm does not only passively provide execution of order services. "Market" suggests some form of pro-activeness on behalf of the firm to the client and in this context, is only likely to be relevant in an advised scenario.

With regards to technical advice point 27 (pg 50), clarity should be provided on what is understood by the "final" distributor. There may be examples when a transaction is concluded by a firm, but they are purely providing execution of order services. However, the client has appointed an investment advisor or discretionary portfolio manager, appropriately licensed. The distributor obligations should not apply to an investment firm in such a case. We would suggest that similar wording to that in Article 26 of MiFID II (provision of services through the medium of another investment firm) could be included in the technical advice to the Commission, clarifying where the responsibility lies.

Finally, we note that MiFID does not make a distinction between "Pure Manufacturer" and "Retail Manufacturer" as helpfully laid out by the FCA in the "Responsibilities of Providers and Distributors for Fair Treatment of Customers" regulatory guidelines ("FCA Guidelines"). The intention of the FCA's Guidelines was to increase investor protection by strengthening existing responsibilities of product providers and distributors whilst also addressing scenarios where the delineation between product provider and distributor is unclear and, therefore, requiring responsibilities to be allocated differently. The FCA has taken a practical approach when considering responsibilities at various stages of the product life cycle and importantly, recognises that the respective responsibilities of product providers and distributors will flow from the actual roles or functions undertaken in each transaction and not merely the label given to a firm in respect of a particular transaction. The FCA Guidelines also permit product providers and distributors to agree between themselves how to apportion the various responsibilities in many circumstances.

<ESMA\_QUESTION\_19>

**Q20: Are there any other product governance requirements not mentioned in this paper that you consider important and should be considered? If yes, please set out these additional requirements.**

<ESMA\_QUESTION\_20>

AFME Response

No. We believe that the requirements are already very comprehensive – see also our comments above. Rather than introducing additional requirements, ESMA should seek to streamline and clarify the advice provided in line with our suggestions.

<ESMA\_QUESTION\_20>

**Q21: For investment firms responding to this consultation, what costs would you incur in order to meet these requirements, either as distributors or manufacturers?**

<ESMA\_QUESTION\_21>

AFME Response

We believe that significant costs would be incurred by both distributors and manufacturers across the EEA. Estimating these potential costs is difficult given the lack of clarity regarding the exact nature of obligations which ESMA is seeking to impose. We note that UK firms will already be required to comply with the FCA rules and guidelines.

<ESMA\_QUESTION\_21>

## **2.8. Safeguarding of client assets**

**Q22: Do you agree with the proposal for investment firms to establish and maintain a client assets oversight function?**

<ESMA\_QUESTION\_22>

AFME Response

No. In jurisdictions such as the UK, a requirement for a single officer to be appointed with responsibilities for the firm's compliance with its obligations for safeguarding clients' instruments and funds already exists, and we are supportive of this arrangement continuing. Where investment firms do not currently have such an officer, there may be implementation challenges. The proposed technical advice should make it clear that it is permissible for the single officer to possibly hold other responsibilities, as this may be appropriate for small firms. Additionally, whilst supporting the proposal, the draft advice should provide sufficient flexibility for firms to appoint an appropriate single officer bearing in mind their own legal structure and diversity of operations.

<ESMA\_QUESTION\_22>

**Q23: What would be the cost implications of establishing and maintaining a function with specific responsibility for matters relating to the firm's compliance with its obligations regarding the safeguarding of client instruments and funds?**

<ESMA\_QUESTION\_23>

AFME Response

AFME believes that any such costs would not be material, where firms can leverage their existing organisational structures. Particularly, where a group operates via many subsidiaries throughout the EU, but operates its client assets safeguarding activities on a centralised basis, there would appear to be little benefit in appointing a single oversight officer in each subsidiary. In such cases, AFME would recommend that such an officer be appointed at the highest level of the group operating in the EU.

<ESMA\_QUESTION\_23>

**Q24: Do you think that the examples in this chapter constitute an inappropriate use of TTCA? If not, why not? Are there any other examples of inappropriate use of or features of inappropriate use of TTCA?**

<ESMA\_QUESTION\_24>

#### AFME Response

AFME generally agrees that TTCA arrangements should not be used without proper consideration and with the examples provided.

It should be noted that the Financial Stability Board (“FSB”) published a policy framework for addressing certain ‘shadow banking’ risks in August 2013, including express recommendations relating to rehypothecation and title transfer arrangements. It is submitted that ESMA should take account of the work by the FSB in this space in order to ensure global consistency as there is a danger of duplicative regimes.

The FSB makes a distinction between arrangements where client assets are held in custody and are subject to a right of rehypothecation, dependant on specific market and portfolio conditions, as opposed to circumstances where assets are at the outset transferred to firms under a TTCA. The reasoning behind the distinction lies in the view that under TTCA, parties are fully aware of the agreement they are entering into prior to transferring any assets, whereas in custody relationships the firm may exercise its right to rehypothecation at a later date and it is important that sufficient disclosure be provided to clients of the exercise of such rights, such that the client is able to evaluate its exposure in the event of a failure of the firm.

With respect to non-retail clients, it should be noted that the proposed framework for inappropriate arrangements implies that there is an objective view as to what constitutes an appropriate arrangement and what falls outside of this. The appropriate level should be determined by prudent risk management, which may be set by each client’s risk appetite. Furthermore, non-retail or professional clients are sophisticated investors who understand the risks associated with the arrangements entered into and should be free to engage with firms on mutually negotiated terms. The appropriateness of these arrangements should be judged with respect to each agreement, based on the nature of the client’s portfolio and the obligations of the parties.

The list set out by ESMA should be non exhaustive and it should be recognised that the examples provided by ESMA may not necessarily be inappropriate in all cases. The proposals are not appropriate to a number of products where the standard market documents have been developed over a number of years and are constructed with TTCA.

For example, in cleared derivatives business, a number of clearing houses may require clearing firms to take client margin under a TTCA arrangement. As such, the clearing house in question may not permit clearing members to accept any margin collateral other than by TTCA, and may mandate three way agreements between the client, the clearing member and the central counterparty.

Further, for clearing services, there may be scenarios in which there is no relationship between the client’s obligation and the TTCA. One scenario is where the client prefunds its clearing ac-

count for transactions it has not yet entered into. Such prefunding may be prudent operationally or from a risk management perspective. A further scenario is where an individually segregated client has chosen to provide margin collateral surplus to the margin requirements of the clearing member and the central counterparty and this is carried out under mandatory documentation which requires title transfer.

There is an existing obligation to act in a client's best interests, and this should be the test for whether any particular TTCA arrangement is appropriate, not the prescriptive tests outlined in the draft advice. In particular, it will be very difficult to identify and quantify a client's liability or consideration and the TTCA arrangements where a blanket TTCA is in place over multiple business lines. In addition, there are circumstances where clients will want their TTCA arrangements to be in excess of their liability to prevent the need for excess margin calls. As such, the prescriptive tests will be inflexible and may harm the client's interests, which is why the broader test of acting in the client's best interests is to be preferred.

TTCA arrangements may be appropriate for legal reasons, for instance in order to enhance the enforceability of collateral with clients located in a given jurisdiction.

<ESMA\_QUESTION\_24>

**Q25: Do you agree with the proposal to clarify that the use of TTCA is not a freely available option for avoiding the protections required under MiFID? Do you agree with the proposal to place high-level requirements on firms to consider the appropriateness of TTCA? Should risk disclosures be required in this area? Please explain your answer. If not, why not?**

<ESMA\_QUESTION\_25>

#### AFME Response

No. Whilst AFME broadly supports elements of the proposal, the ESMA guidance should only prevent the use of TTCA where this is carried out by a firm seeking to avoid client asset segregation. It is inappropriate to prohibit TTCA where it is in widespread use as part of industry standard documentation or to comply with applicable market rules or to ensure that collateral provided to investment firms is legally enforceable. Were ESMA to require that industry standard documents are re-negotiated, investment firms would be obligated to undertake an extensive exercise to obtain new legal opinions.

AFME does not agree with the proposal to place high level requirements on firms to consider appropriateness of TTCA arrangements. Placing high level requirements on firms to consider the appropriateness of TTCA does not necessarily address the concerns around ensuring the effectiveness of segregation of client assets. By setting out high level appropriateness requirements there may be an unintended impact on the risk process of individual firms.

AFME generally supports the proposal that firms provide clients with risk disclosures. Any such risk disclosures should be generic and firms should have the ability to refer customers to the relevant risk disclosure maintained on the firm's website. However, ESMA should recognise the right of a non-retail customer to enter into a freely negotiated contract with a firm.

The question remains open as to how the investment firm may demonstrate the appropriateness of the TTCA. TTCAs could be agreed between a client and his custodian, and also between counterparties where neither party is acting as the custodian of the other. If the counterparty is not the custodian at the same time, then the custodian only receives the instruction to transfer the respective securities to a third party, however the custodian is not aware of the underlying transaction. The custodian cannot check the appropriateness of the TTCA: this would be the responsibility of the two counterparties.

<ESMA\_QUESTION\_25>



**Q26: Do you agree with the proposal to require a reasonable link between the client's obligation and the financial instruments or funds subject to TTCA?**

<ESMA\_QUESTION\_26>

AFME Response

No. AFME does not support this proposal, as it would be inappropriately disruptive to market documentation in a number of situations, as we describe above.

<ESMA\_QUESTION\_26>

**Q27: Do you already make any assessment of the suitability of TTCAs? If not, would you need to change any processes to meet such a requirement, and if so, what would be the cost implications of doing so?**

<ESMA\_QUESTION\_27>

AFME Response

No. Where AFME Members deal with retail clients, they currently undertake such appropriateness assessments. However, professional customers have the ability to assess for themselves the risks of entering into a TTCA or they generally have easy access to appropriate independent legal and risk advice. Where firms provide services or enter into transactions with non-retail clients, they may not have sufficient information about the overall activity of the non-retail client to be in a position to assess the appropriateness of TTCA arrangements to the client's particular circumstances. For instance, a non-retail client may be proactively managing its credit risk exposure to a number of financial institutions and have deliberately chosen to deal with a firm under a TTCA arrangement so that its counterparty risk management systems can monitor exposure to a particular counterparty rather than a number of institutions holding client money deposits (as is the case where client money is diversified at a number of credit institutions).

Finally, should such suitability assessments be extended to non-retail customers it is inevitable that firms will incur additional costs that will ultimately be passed onto customers.

<ESMA\_QUESTION\_27>

**Q28: Are any further measures needed to ensure that the transactions envisaged under Article 19 of the MiFID Implementing Directive remain possible in light of the ban on concluding TTCAs with retail clients in Article 16(10) of MiFID II?**

<ESMA\_QUESTION\_28>

AFME Response

No. AFME does not believe that any further measures are needed in respect of TTCA for retail customers, however ESMA should permit such customers to enter into stock lending and repo transactions where these transactions have been the subject of an appropriateness assessment for each retail customer. ESMA should be aware that the securities lending agreement in use across the market operates with TTCA.

<ESMA\_QUESTION\_28>

**Q29: Do you agree with the proposal to require firms to adopt specific arrangements to take appropriate collateral, monitor and maintain its appropriateness in respect of securities financing transactions?**

<ESMA\_QUESTION\_29>

AFME Response





No. There are existing market practices that result in ex-ante assessment and selection of eligible collateral. The process of advising clients on eligible collateral to be accepted against clients' assets form part of the framework agreements with clients and is documented in standard market documentation. Accordingly, AFME sees no reason to alter the present situation.

<ESMA\_QUESTION\_29>

**Q30: Is it suitable to place collateral, monitoring and maintaining measures on firms in respect of retail clients only, or should these be extended to all classes of client?**

<ESMA\_QUESTION\_30>

AFME Response

No. AFME suggests that placing collateral, monitoring and maintaining measures should be imposed on firms only where they deal with retail clients as such clients, by their definition, are unsophisticated. Conversely, non-retail clients will be more aware of the potential risks of such transactions and have elected to conduct them.

<ESMA\_QUESTION\_30>

**Q31: Do you already take collateral against securities financing transactions and monitor its appropriateness on an on-going basis? If not, what would be the cost of developing and maintaining such arrangements?**

<ESMA\_QUESTION\_31>

AFME Response

Whilst AFME Members currently take collateral against securities financing transactions and closely monitor such collateral in terms of economic exposure in line with standard market documentation. until we obtain clarification on "appropriateness" we are not placed to answer this question.

<ESMA\_QUESTION\_31>

**Q32: Do you agree that investment firms should evidence the express prior consent of non-retail clients to the use of their financial instruments as they are currently required to do so for retail clients clearly, in writing or in a legally equivalent alternative means, and affirmatively executed by the client? Are there any cost implications?**

<ESMA\_QUESTION\_32>

AFME Response

No. AFME supports such a measure provided such consent is given once before the initial relevant transaction and we would expect such consent to be generally provided in the relevant client contract. AFME also recommends that ESMA gives full consideration to transitional arrangements for non-retail customers who currently provide financial instruments for collateral and securities financing transactions. AFME Members believe that any such costs following the introduction of such a requirement would not be material.

Furthermore, the scope of when risk disclosures will be required should be limited to instances where client assets are held in custody and are subject to a right of rehypothecation as distinguished from those instances where assets are at the outset transferred to firms under a TTCA. It is submitted that in the latter case, the risks should be self evident in the terms of the agreement between the firm and client.

<ESMA\_QUESTION\_32>

**Q33: Do you anticipate any additional costs in order to comply with the requirements proposed in relation to securities financing transactions and collateralisation? If yes, please provide details.**

<ESMA\_QUESTION\_33>

AFME Response

AFME is not in position to answer this question, particularly without knowing the extent to which the additional requirements will depart from current market practices.

<ESMA\_QUESTION\_33>

**Q34: Do you think that it is proportionate to require investment firms to consider diversification of client funds as part of the due diligence requirements when depositing client funds? If not, why? What other measures could achieve a similar objective?**

<ESMA\_QUESTION\_34>

AFME Response

Yes, AFME Members generally support a recommendation that investment firms should consider diversification of client funds.

<ESMA\_QUESTION\_34>

**Q35: Are there any cost implications to investment firms when considering diversification as part of due diligence requirements?**

<ESMA\_QUESTION\_35>

AFME Response

Should a requirement be introduced to consider diversification, there will be cost implications for investment firms operating in Member States that do not presently have such a requirement. Conversely, for investment firms operating in Member States that do currently have a requirement to consider diversification, any additional costs are likely to be minimal.

<ESMA\_QUESTION\_35>

**Q36: Where an investment firm deposits client funds at a third party that is within its own group, should an intra-group deposit limit be imposed? If yes, would imposing an intra-group deposit limit of 20% in respect of client funds be proportionate? If not, what other percentage could be proportionate? What other measures could achieve similar objectives? What is the rationale for this percentage?**

<ESMA\_QUESTION\_36>

AFME Response

No. AFME Members do not believe that investment firms should be limited to depositing a maximum of 20% of client funds with intra-group firms. Members believe that such an intra-group limit could be considered, alongside other measures, by an investment firm when assessing how best to safeguard client funds. Members are concerned that an intra-group deposit limit of 20% appears to have been suggested without the consideration of alternative proportions or indeed alternative measures which might better safeguard client funds.

Should ESMA recommend an intra-group limit of 20%, AFME Members believe it should be introduced on a “comply or explain” basis, where investment firms would have the option of

explaining to their national competent authorities what alternative measures they have put in place to safeguard client funds.

Members make these suggestions because they are concerned that in some cases, for example when markets are stressed, intra-group deposit limits could result in client funds having to be placed in financial institutions that have a lower credit rating than the group financial institution. It is critical that if a mandatory diversification requirement were to be introduced, it may be waived when there is a significant positive difference between the creditworthiness of an affiliated credit institution and the median creditworthiness of the firms' panel of unaffiliated credit institutions which hold client money in more benign markets. ESMA may also wish to consider encouraging central banks to accept client money deposits in times of market stress.

<ESMA\_QUESTION\_36>

**Q37: Are there any situations that would justify exempting an investment firm from such a rule restricting intra-group deposits in respect of client funds, for example, when other safeguards are in place?**

<ESMA\_QUESTION\_37>

AFME Response

Additional safeguards that could mitigate against concentration risk include senior management approval, ongoing monitoring of credit ratings and credit default swap rates of the relevant institutions, and a prohibition on unbreakable term deposits, etc.

Client should be permitted to keep their funds within the same group where they wish to rely on a group with a higher credit rating than other deposit-takers outside the group. As part of its due diligence an investment firm should hold client funds with appropriate credit institutions based on a number of factors including an overall assessment of prudential soundness, credit rating and the quality of regulatory supervision of the credit institution where client funds are to be deposited.

<ESMA\_QUESTION\_37>

**Q38: Do you place any client funds in a credit institution within your group? If so, what proportion of the total?**

<ESMA\_QUESTION\_38>

AFME Response

AFME Members operating in Member States that impose a mandatory diversification requirement, do not, as a matter of course, deposit the maximum permitted percentage of their client funds with intra-group depositories. Due to the effect of the timing of the settlement by financial institutions of transactions, whether they be client buys or client sells, the practical effect is to deposit a lower percentage of client funds with intra-group depositories.

AFME Members operating in Member States which do not currently impose a mandatory diversification requirement, may, on occasion, place a significant proportion of their client funds with a credit institution within the group.

<ESMA\_QUESTION\_38>

**Q39: What would be the cost implications for investment firms of diversifying holdings away from a group credit institution?**

<ESMA\_QUESTION\_39>



### AFME Response

Firms operating in Member States which do not currently operate a mandatory diversification requirement would incur costs linked to initial and ongoing due diligence on multiple credit institutions. AFME Members based in Member States that already operate a mandatory diversification requirement would incur lower transition costs.

<ESMA\_QUESTION\_39>

**Q40: What would be the impact of restricting investment firms in respect of the proportion of funds they could deposit at affiliated credit institutions? Could there be any unintended consequences?**

<ESMA\_QUESTION\_40>

### AFME Response

From the viewpoint of the group, it is probable that it would suffer a fall in net interest income arising from the holding of client funds within the group, if the requirement to diversify client funds is combined with the requirement that such funds are readily accessible by the firm or by the client (e.g. by being maintained on overnight deposit, breakable term deposit or similar arrangements). Also, depending on how the group accounts for client funds in its financial statements i.e. whether such funds are held on or off the balance sheet, there may be consequential effects on the calculation of the group's leverage ratio for prudential purposes. From the client's viewpoint, there may be a fall in interest earned on the deposit.

Where investment firms act as a clearing or settlement agent, it may be considered unsound to separate the overview of financial instruments held for the client in custody/safekeeping and their movements from the full overview of the cash funds and the cash movements. It is beneficial to have oversight of at least those cash amounts that are required for related securities movements in order to monitor the totality of the client's activities. As clearing and settlement activities tend to fluctuate in volume over time, it is important that adequate cash funds are readily accessible.

<ESMA\_QUESTION\_40>

**Q41: What would be the cost implications to credit institutions if investment firms were limited in respect of depositing client funds at credit institutions in the same group?**

<ESMA\_QUESTION\_41>

### AFME Response

See our answer to the previous question. Also, credit institutions may have to seek alternative sources of finance, with a higher interest cost, to fund its own activities and those of the rest of the group.

<ESMA\_QUESTION\_41>

**Q42: Do you agree with the proposal to prevent firms from agreeing to liens that allow a third party to recover costs from client assets that do not relate to those clients, except where this is required in a particular jurisdiction?**

<ESMA\_QUESTION\_42>

### AFME Response

AFME supports this proposal.

ESMA may wish to consider a rule which address the issue of inappropriate liens, yet provides for a broader carve-out for where liens may be permissible and which sets out the circumstances under which liens may be used. The rule may not only include jurisdictions where this may be a requirement but also operating terms of a securities depository, securities settlement system or central counterparty.

<ESMA\_QUESTION\_42>

**Q43: Do you agree with the proposal to specify specific risk warnings where firms are obliged to agree to wide-ranging liens exposing their clients to the risk?**

<ESMA\_QUESTION\_43>

AFME Response

No. AFME only supports this proposal to the extent that such risk warnings are generic and not customised to each particular jurisdiction where wide ranging liens are taken.

<ESMA\_QUESTION\_43>

**Q44: What would be the one off costs of reviewing third party agreements in the light of an explicit prohibition of such liens, and the on-going costs in respect of risk warnings to clients?**

<ESMA\_QUESTION\_44>

AFME Response

AFME Members believe that the implementation costs of such a proposal would be material as they would involve the commissioning of advice by local law firms in each jurisdiction. Such advice would need to be reviewed on a regular basis to ensure it remains valid. Additionally, there would also be costs in summarising this advice to customers, both on the introduction of such a requirement and then thereafter.

<ESMA\_QUESTION\_44>

**Q45: Should firms be obliged to record the presence of security interests or other encumbrances over client assets in their own books and records? Are there any reasons why firms might not be able to meet such a requirement? Are there any cost implications of recording these?**

<ESMA\_QUESTION\_45>

AFME Response

AFME Members believe that security interests are properly recorded in the client contracts of investment firms. Any additional requirement that this information is consolidated centrally is duplicative and onerous. Such a proposal, including any obligation to maintain a specific liens register over and above any standard client asset register, would incur disproportionate costs with no benefit for customers. Firms would incur costs in calculating the quantum of security interests and other encumbrances on a daily basis. The quantum is likely to vary widely on a day to day basis due the nature of securities trading by clients and general price movement on financial instruments. Additionally, ESMA's proposals that investment firms are able to make information readily available to insolvency practitioners, relevant authorities and those responsible for failed institutions should be adequate to ensure that information on security interests is readily accessible in the event of a firm's demise. This specific part of the draft technical advice would render any additional register or central record of security interests duplicative of other recovery and resolution plans.



<ESMA\_QUESTION\_45>

**Q46: Should the option of ‘other equivalent measures’ for segregation of client financial instruments only be available in third country jurisdictions where market practice or legal requirements make this necessary?**

<ESMA\_QUESTION\_46>

AFME Response

No. Whilst AFME understands ESMA’s reasoning behind this proposal, we question whether any “other equivalent measures” may be proportionate. Whilst clients always have the option of opening their own account in the jurisdiction in question and permitting the investment firm to transfer the client’s financial instruments in and out of the account, investment firms will be faced with considerable operational challenges if a large number of clients elected to open their own accounts. It may be, on occasion, that if segregation is not available in a particular market, investment firms may not offer their clients the ability to trade and hold securities in those markets.

Article 3 of the MiFID Implementing Directive permits, under certain conditions, the provision of asset safekeeping in third jurisdictions that do not comply with EU standards, by requiring clients to give prior consent to their assets being held in such countries and by prohibiting retail clients from using this option. AFME recommends that Article 3 be maintained.

Any potential change of Article 16(1) of the MiFID Implementing Directive should consider the entire custody chain, and the respective level in the custody chain and should be consistent with the requirements of Article 38 of the Central Securities Depositories Regulation (individual segregation and omnibus accounts), Article 39 EMIR (clearing segregation) and AIFMD (depository needs to segregate proprietary assets from fund assets in the books of the custodian).

<ESMA\_QUESTION\_46>

**Q47: Should firms be required to develop additional systems to mitigate the risks of ‘other equivalent measures’ and require specific risk disclosures to clients where a firm must rely on such ‘other equivalent measures’, where not already covered by the Article 32(4) of the MiFID Implementing Directive?**

<ESMA\_QUESTION\_47>

AFME Response

AFME Members support such a proposal although we do not support the use of specific risk disclosures to each client on a market by market basis. There is a risk that multiple similar risk disclosures would go unread as well as resulting in significant costs being incurred. As an alternative, AFME recommends that a generic segregation disclosure be provided to each client.

<ESMA\_QUESTION\_47>

**Q48: What would be the on-going costs of making disclosures to clients when relying on ‘other equivalent measures’?**

<ESMA\_QUESTION\_48>

AFME Response

AFME Members believe that such costs would not be material.

<ESMA\_QUESTION\_48>



**Q49: Should investment firms be required to maintain systems and controls to prevent shortfalls in client accounts and to prevent the use of one client’s financial instruments to settle the transactions of another client, including:**

<ESMA\_QUESTION\_49>

AFME Response

No. Whilst AFME Members currently employ the measures suggested in order to minimise the possibility of settlement failure, they believe, given the nature of the securities settlements which will include the aggregation of individual buys and sells on behalf of individual clients when combined with the firm’s own (principal) buys and sells in any one security, that such a proposal would present significant operational challenges and would be costly to implement.

Additionally, where shortfalls in client accounts occur, ESMA may wish to consider the UK rules which require firms to ensure that in such instances equivalent money is segregated on behalf of the client.

It is essential that the words “to prevent” are removed from the draft technical guidance to avoid any inference that settling securities through omnibus structures are problematic. Upon reading ESMA’s policy statement which accompanies draft technical advice paragraph 18, AFME understands that it is not ESMA’s intention to prevent investment firms from settling securities through omnibus accounts. Rather the provisions are geared at minimising shortfalls that may eventuate from investment firms failing to impose procedures and controls. If the words “to minimise the risks of shortfalls arising out of the use of.....” are inserted to replace the words “to prevent the intended use of...” the obligations on firms in relation to omnibus accounts could be clarified.

Furthermore, where the draft advice mentions the “projected” requirement, AFME would be grateful if ESMA confirms that the “projection” refers to all settlement obligations on a specific day rather than a “projection” of all trades which may fail at some point in the future. If the latter interpretation were to prevail, the “projection” by its very nature would be extremely difficult to predict.

<ESMA\_QUESTION\_49>

**Q50: Do you already have measures in place that address the proposals in this chapter? What would be the one-off and on-going cost implications of developing systems and controls to address these proposals?**

<ESMA\_QUESTION\_50>

AFME Response

It appears to AFME Members that most of ESMA’s proposals are significantly aligned to the UK’s regulatory regime on client assets and monies. To the extent that AFME Members currently operate in the UK, they currently employ most, if not all, of the proposals in this chapter. AFME is not in a position to respond on the question of costs.

<ESMA\_QUESTION\_50>

**Q51: Do you agree that requiring firms to hold necessary information in an easily accessible way would reduce uncertainty regarding ownership and delays in returning client financial instruments and funds in the event of an insolvency?**

<ESMA\_QUESTION\_51>

AFME Response

Yes. AFME supports such a proposal as it is currently required in the Resolution and Recovery Directive to be put in place for large investment firms throughout the EU.

<ESMA\_QUESTION\_51>

**Q52: Do you think the information detailed in the draft technical advice section of this chapter is suitable for including in such a requirement?**

<ESMA\_QUESTION\_52>

AFME Response

Yes

<ESMA\_QUESTION\_52>

**Q53: Do you already maintain the information listed in a way that would be easily accessible on request by a competent person, either before or after insolvency? What would be the cost of maintaining such information in a way that is easily accessible to an insolvency practitioner in the event of firm failure?**

<ESMA\_QUESTION\_53>

AFME Response

Yes. To the extent that AFME Members are deemed to be “large firms”, they currently meet the proposal. It is their experience that the implementation costs of such a proposal were material and they encountered significant implementation challenges.

<ESMA\_QUESTION\_53>

## **2.9. Conflicts of interest**

**Q54: Should investment firms be required to assess and periodically review - at least annually - the conflicts of interest policy established, taking all appropriate measures to address any deficiencies? Please also state the reason for your answer.**

<ESMA\_QUESTION\_54>

AFME General Comment

The draft technical advice fails to recognise some important points about the disclosure of potential conflicts of interests. In some cases, disclosing a potential conflict is part of the suite of tools used by a firm to minimise the likelihood of a potential conflict actually crystallising. For example, in the context of corporate finance advice, due to the highly specialised nature of the advice required and the limited availability of expertise, it is common for firms to have knowledge or other client relationships that, absent specific conflict management measures, would prevent the firm from acting. As part of their conflict management measures, firms commonly disclose to affected clients and potential clients that they might have such knowledge and relationships and then explain how they have organised themselves internally to avoid the possibility of such potential conflicts having an adverse effect on the clients concerned. Clients fully expect such disclosures and use them to decide whether or not to instruct a firm (or, in some cases, to suggest additional precautionary measures). It would be perverse if rules designed to protect client interests resulted in clients having less information on which to base their decision on whom to instruct.



It should also be noted that in some countries disclosure of a potential conflict will also be driven by other legal requirements (for example, in the UK, fiduciary duties). In some other cases, disclosure may be forbidden by local law (e.g. banking secrecy). It is important that ESMA requirements recognise this and avoid putting the firm in the position of having to breach one rule, or be at a disadvantage, in order to comply with another. ESMA should therefore explicitly state in its advice that the conflicts disclosure requirements are without prejudice to a firm's legal duties.

Finally, when a conflict of interest must be disclosed, it is important that the disclosure does not affect adversely any of the parties involved. This may be the case if the firm is required to disclose the actual conflict, as opposed to the type of conflict. In some cases, a firm may only be able to disclose generally that there might be a conflict because specifying the nature of the conflict would adversely affect one of the parties involved. Therefore we suggest that there should not be requirements about the contents of the disclosures, but rather a requirement that firms make disclosures in a manner that is adequately balances the interests of all involved.

#### AFME Response

No, we do not agree with assessing “at least annually” but we agree with periodically assessing and reviewing the conflicts of interest policy and taking all reasonable steps to address any deficiencies. The frequency of such assessments and reviews should be left to the individual firm's management to decide, employing a risk-based approach such that the timing of reviews might vary depending on the conflicts under review. It is too prescriptive and likely to impose unnecessary additional cost for no reduction in risk to say “at least annually”; it might be perfectly acceptable to undertake this exercise less frequently than that. We note that the conflicts policy consists of two parts: the conflicts policy and the conflicts register describing the conflicts and their mitigation. The conflicts policy will be reviewed and updated periodically as all other policies. However, the frequency of updates to the register should be driven by new activities and organisational changes.

We also note that in certain situations (e.g. client vs client conflicts) there may be constraints on a firm's ability to provide a “specific description” of the conflict due to e.g. bank secrecy legislation. ESMA should clarify that a disclosure of specific conflicting transactions is not required in order to fulfil this obligation (see also our general comments).

<ESMA\_QUESTION\_54>

**Q55: Do you consider that additional situations to those identified in Article 21 of the MiFID Implementing Directive should be mentioned in the measures implementing MiFID II? Please explain your rationale for any additional suggestions.**

<ESMA\_QUESTION\_55>

#### AFME Response

No, but if any additional situations are mentioned it would be helpful to have all the situations listed in one place.

<ESMA\_QUESTION\_55>

**Q56: Do you consider that the distinction between investment research and marketing communications drawn in Article 24 of the MiFID Implementing Directive is sufficient and sufficiently clear? If not, please suggest any improvements to the existing framework and the rationale for your proposals.**

<ESMA\_QUESTION\_56>



### AFME Response

Generally we believe that the MiFID 1 definitions have worked well and stood the test of time. The definitions within Article 24, supported by the relevant provision of Directive 2003/125/EC and 2004/39/EC, provide sufficient distinction between investment research and marketing communications, both in terms of published widely distributed research product (i.e. published research report) and also other research products (one on one client communications etc.)

<ESMA\_QUESTION\_56>

**Q57: Do you consider that the additional organisational requirements listed in Article 25 of the MiFID Implementing Directive and addressed to firms producing and disseminating investment research are sufficient to properly regulate the specificities of these activities and to protect the objectivity and independence of financial analysts and of the investment research they produce? If not, please suggest any improvements to the existing framework and the rationale for your proposals.**

<ESMA\_QUESTION\_57>

### AFME Response

Yes we agree that the organisational requirements are sufficiently broad to protect the objectivity and independence of investment recommendations, consideration should be given to the definition of 'relevant person' to the extent referred to here, as a strict interpretation could limit the provision to the analyst him- or herself, even though a far wider group is involved in the preparation (Research Management, Supervisory Analysts etc.).

There are a number of terms that are subject to interpretation and ESMA could consider providing further guidance on the following:

Article 25 defines "**related financial instrument**" as a financial instrument the price of which is closely affected by price movements in another financial instrument, which is the subject of investment research (including a derivative). Given the outcome of the recent UK Hannam case, where the Tribunal upheld the decision of Financial Conduct Authority to find Ian Hannam guilty of market abuse, can ESMA clarify what is meant by "closely affected" – is a materiality assessment made?

The disclosure requirement states: "*When disclosure of specific conflicts of interest is required, the disclosure shall clearly state that the organisational and administrative arrangements established by the investment firm to prevent or manage that conflict are not sufficient to ensure, with **reasonable confidence**, that the risks of damage to the interests of the client will be prevented*". However, the statement does not circumscribe or define what is meant by "**with reasonable confidence**" and, therefore, is open to varying interpretations.

**"Durable medium" – which clients concerned:** ESMA does not request whether we agree with the detailed information to be provided to clients which is an important aspect of the draft technical advice. Item 3 of the technical advice does not clarify to which type of client this disclosure should be made. There should be no obligation to use a durable medium when providing information to professional clients and eligible counterparties. The means of distribution to such clients should be left much more flexible.

In addition to the above, "**Durable medium**" should also be further clarified in other respects. For example a number of firms provide current disclaimers on their webpage and this should be sufficient as a durable medium.

<ESMA\_QUESTION\_57>

## 2.10. Underwriting and placing – conflicts of interest and provision of information to clients

### Q58: Are there additional details or requirements you believe should be included?

<ESMA\_QUESTION\_58>

#### AFME Response

#### **Scope of response**

1. This response relates to section 2.10 (on underwriting and placing) of the consultation paper (**CP**) and related questions Q58 to Q62, in the context of issuers considering primary and secondary offerings in the equity capital markets. This includes consideration of their application to banks working on initial public offerings (IPOs) and secondary offerings by listed issuers (including rights issues, open offers and placings). As we feel it is important to directly connect our comments with the text of the draft technical advice, we include a mark-up showing changes that reflect our responses.

#### **Summary**

2. The usual practice in relation to equity market offerings is for an issuer to engage one or more banks to provide underwriting services and for those banks not to provide corporate finance advice. We believe the guidance should cover this standard option. There are a wide variety of reasons for an issuer not to wish to receive corporate finance advice, including that it has sufficient internal or other professional resources or simply that it prefers to take its own decisions. Our comments and proposed amendments to the draft technical advice seek to make clear that issuers may engage investment firms to provide only underwriting services.

3. Where expressly agreed with an issuer, investment firms provide corporate finance advice either alone or in conjunction with underwriting services. Where these services are provided by the same investment firm but at different points in time, with engagement letters that make clear when the role of the investment firm changes (for example, when it ceases to provide corporate finance advice and starts to provide execution only underwriting services), there would be no potential conflict as a consequence. Where both corporate finance advice and underwriting services are provided by the same investment firm at the same time, however, depending on the scope of such corporate advice, conflicts may arise that will need to be appropriately managed. Our comments and proposed amendments to the draft technical advice seek to make clear that such potential conflicts should be managed through the existing processes and procedures in place at investment firms.

4. In order to consider the details and requirements put forward in the CP, it is important to understand the current practical and legal relationships between issuers and banks providing underwriting services and corporate finance advice in the equity capital markets. We include a summary of current market practice in our response below. In particular, the key points which we would like to highlight are that:

(a) the roles of underwriter and corporate finance adviser are distinct. Requiring corporate finance advice to be provided as part of the provision of underwriting services on every occasion would necessarily increase the complexity of, and the time required for, the underwriting and execution of offerings. It would also increase the fees charged by each member of an underwriting syndicate, to the detriment of issuer clients and, depending on the scope of such corporate finance advice, impose unnecessary conflicts of interests on investment firms;

(b) where a bank is providing underwriting services it does not take on corporate finance advisory duties to the issuer client in relation to the price, timing or size of a proposed offer because it may also have regard to its own interests, including its underwriting risk and market reputation, when giving recommendations and feedback to the issuer client;

(c) issuers, typically entities with significant internal resources, are well able to make decisions regarding an offering and may fairly conclude that they do not need to purchase corporate finance advice in addition to the assistance they will receive from their legal and accounting advisers and the underwriters; and

(d) investment firms already have in place processes and procedures designed to manage conflicts situations that may arise where they provide both corporate finance advice and underwriting services.

We discuss these points in more detail below.

### **Distinct underwriter and corporate finance adviser roles**

5. The CP and draft technical advice appear to proceed on the basis that a bank acting as underwriter will in all cases provide corporate finance advice to its issuer client. In practice, however, the roles of underwriter and of corporate finance adviser are distinct and treated as such by both banks and issuer clients when mandates are agreed. While an issuer may choose to mandate an investment firm to provide corporate finance advice and also underwriting services on an offering, issuers may choose to proceed without corporate finance advice or to split the two roles either in time or between different investment firms.

6. There is a key distinction between corporate finance advice and the recommendations and feedback on pricing and allocations given by an investment firm providing underwriting services. Corporate finance advice will be provided under a specific mandate with an associated fee, and, subject to the terms of such mandate, will likely require the bank to engage in an broad issuer-focused exercise to consider all implications particular to the issuer client, taking into account not only market factors but also the detail of an issuer client's circumstances and objectives. Recommendations and feedback, in contrast, are information and assistance provided by a commercial counterparty within contractually agreed boundaries. Recommendations will factor into an issuer client's decision but the issuer itself will interpret the information in light of the issuer client's individual requirements. The underwriter may, and we believe should, have regard not only to the issuer's position but also to other factors, such as its own underwriting risk and market reputation and the general regulatory objective of market stability.

7. We set out below a summary of the role typically taken by an investment firm solely providing underwriting services and, in contrast, the role generally assumed by an investment firm providing corporate finance advice.

(a) *Underwriter role* – A bank providing underwriting services is engaged to assist in the execution of an issue. In our experience, an issuer client will already have determined that it wishes to undertake a specific issue: a debt offering and an IPO are undertaken for very different reasons and an issuer would select its syndicate accordingly. A request for proposal will then be sent out by the issuer client to a wide number of banks requesting a fee proposal based on the specific underwriting services for which the issuer client wishes to contract. Banks successful in this process will then enter into an engagement letter with the issuer client, negotiated on arms-length terms between commercial counterparties, that sets out clearly the extent of the role. The provision of underwriting services will include providing assistance in executing and structuring the transaction and providing recommendations and feedback on market demand to the issuer

client to assist in its decision on pricing and allocation of the issue. The fee charged by the underwriting bank will reflect the nature of those services.

While solely providing underwriting services, a bank will not provide corporate finance advice to an issuer client. An underwriter, as purchaser of last resort, will need both to manage its own underwriting risk and have regard to its reputation in the market and the interests of all market participants, including regulators, in producing a stable market. In the UK, the engagement letter will accordingly make clear that the underwriter is not acting in a fiduciary capacity and is not providing corporate finance advice to the issuer client with respect to the offer.

It should be noted that underwriters, given their expertise, are sometimes asked by an issuer to provide general assistance in relation to the execution of an offer, although this is not always the case. Such general assistance may include providing views and recommendations on listing venues or listing requirements, providing assistance with structuring the offer, managing the timetable of the offer or liaising with regulators. None of these services constitute advice to an issuer “to proceed with the offer” nor should they be viewed as any other form of corporate finance advice that could create a conflict of interest with the underwriting role undertaken by the same investment firm. In addition, in the UK, an issuer seeking admission of shares to the premium listing segment of the Official List of the UK Financial Conduct Authority is required to appoint an investment firm as a sponsor which, in general terms, has the role of ensuring that the offer transaction is conducted in compliance with certain UK regulatory/listing requirements. The sponsor’s overriding obligation, in performing sponsor services, is to the regulator and not the issuer. Often, the same investment firm is appointed as sponsor and as an underwriter of the offer. Any services performed by the sponsor should not be viewed as corporate finance advice nor seen as in conflict with such investment firm’s underwriting role.

(b) *Corporate finance advice* – The extent of the corporate finance advice provided by an investment firm taking on this role will depend entirely on the scope agreed with the issuer. An advisory mandate will be entered into, which will include payment of a fee specific to the provision of corporate finance advice. Often, an investment firm providing corporate finance advice will be engaged by an issuer client at an early stage in its consideration of all of its financing options, before any underwriters are appointed in the event that equity financing is chosen. Although the extent of the corporate finance advice requested by an issuer client will vary from issue to issue (and it may be that the issuer wishes only to be advised on, for example, its equity financing options), a corporate finance adviser will generally take a broad view of the options available.

(c) *Where an investment firm provides both corporate finance advice and underwriting services* - - If an issuer client decides to proceed with an equity offering after receiving corporate finance advice on that strategy from a bank, it may wish that bank also to provide underwriting services in relation to the proposed issue. Where this occurs, typically a separate mandate will be entered into (or the existing mandate amended). The corporate finance advice role may be terminated or, if it continues, the new or revised mandate will provide contractually for the two roles (with a separate level of fees for each) to be appropriately managed in accordance with the conflicts procedures of the investment firm.

### **Issuer client choice**

8. As noted above, a key comment is that the draft technical advice should not reduce the ability of an issuer client to enter into a contract for the services that it requires and that the investment firm it wishes to engage is able and willing to provide. The draft technical advice should not limit the choices available to an issuer client.

9. Issuer clients considering an offering in the equity capital markets are usually sophisticated corporates, with knowledgeable boards and market-aware internal resources, and

invariably have the benefit of experienced legal and accounting advice. They should be able to have the flexibility to select the services that best meet their individual requirements and that the investment firms they wish to use can best provide. The fees charged by an investment firm will reflect the services it has agreed to provide to its issuer client. Where it has agreed to act as underwriter, fee levels are likely to be lower than those that apply where the bank also contracts to provide corporate finance advice. An issuer client that has concluded it has sufficient internal or other professional resources, or just wishes to take its own decisions, will not welcome: (i) a requirement that it receive corporate finance advice from each member of what may be a large underwriting syndicate, or (ii) being restricted from using the investment firm(s) that it wants to use, or that can provide the best placing/execution services in the circumstances, because such investment firm(s) cannot, or do not wish to, provide corporate finance advice at the same time as acting as underwriter.

10. An issuer considering an offering in the equity capital markets has a number of options. Given the nature of the equity capital markets transactions that raise primary proceeds, including the need for corporate authorisations and board level approvals, issuers of new shares invariably employ outside legal advisers and accountants in a transaction. An issuer may therefore conclude that it has sufficient internal and other professional resources and does not require or want specific corporate finance advice before engaging with commercial counterparties to execute an offering. If it does wish to receive corporate finance advice, however, it may engage an investment firm for a specified period and fee to provide the corporate finance advice it requires prior to taking a decision to embark on an equity raising, and then hiring an underwriting syndicate to underwrite and execute its transaction.

### **Role of issuer clients in equity offerings**

11. The CP suggests that an investment firm engaged by the issuer as underwriter will have a significant role in the formation of the remainder of the underwriting syndicate and will determine matters such as pricing and allocation. This is not market practice.

(a) *Syndicate formation* - As noted above, the formation of an underwriting syndicate is a process led by the issuer. In contrast to the suggestion in paragraph 10 of the CP, a bank providing underwriting services would not be in a position to influence the choice of other syndicate members. While firms may be asked about the investment firms with which they have previously worked as part of a competitive selection process, the decision regarding composition of the syndicate remains with the issuer. Indeed, in some instances the issuer client may seek to maintain a competitive tension, including with regard to price, between potential syndicate members. Issuers often appoint banks in stages over the course of the process and have the ability to remove banks from, as well as add banks to, the syndicate.

(b) *Pricing* – Paragraph 24 of the CP suggests that banks providing underwriting services will determine the price of an issue. This is not the case: the issuer client will determine the price at which it is willing to proceed with an issue. This decision will be informed by recommendations and feedback given by the underwriters concerning market demand at various price levels, but will primarily be influenced by the funding needs of the issuer client, its intended use of the offering proceeds and any other specific issues that it will weigh up and balance.

An underwriter, acting as a commercial counterparty, will establish the price at which it is willing to act as purchaser of last resort. As well as providing feedback from the market for the issuer to assess and itself determine the price at which it would be comfortable in making the offer. To the extent the issuer client does not wish to proceed at that price level, however, it may exclude that underwriter from the underwriting syndicate or proceed on a non-underwritten basis. In contrast to the suggestion in paragraph 16(iv) that removing an underwriter from a syndicate

may be viewed negatively by the market, this is a step that issuer clients are in practice willing to take when necessary.

It is also worth highlighting that it is market practice for more than one underwriting bank to be involved in building the book of demand for an offering. As such more than one bank will be making recommendations to the issuer client on the price at which it may wish to offer its securities. This process promotes transparency and serves to prevent one bank improperly misreading or misinterpreting the market feedback provided to the issuer client. As noted above issuer clients are focused on retaining competitive tension throughout the offering process.

(c) *Allocation* – The CP suggests that the issuer client’s role in determining the allocation of an issue to investors is limited. Paragraph 25 of the CP in particular states that there will be an increased risk of conflicts of interest arising where an investment firm exercises discretion in relation to the placing of securities. However it is customary for issuer clients to take the controlling role in determining allocations.

The issuer has an integral role in allocation.. An issuer client will have access to the underwriters allocation policy for clients and often even to the online book of demand used by the syndicate to record buy-side demand, and will participate in and lead discussions about the likely investor base. The issuer client will be provided with recommendations based on feedback gained from the bookbuilding process and the underwriter’s broader experience of investor demand, market movements and sentiments and relevant macro-economic factors. In particular in the usual situation of a “soft” underwriting obligation (entered into only after the bookbuilding process is complete), it is market practice for an issuer client to have significant involvement in the allocation process and not uncommon for an issuer client to require that it make the final allocation decision itself. . In the case of a bookbuilt transaction, the issuer will have met with most of the major institutions placing orders and will therefore have views on which investors it will like to see, and in which proportions, in the allocations.

Finally, we note that syndicate members compete for allocations with each other which prevents individual members of the syndicate from unfairly influencing final allocations.

As mentioned above, we provide below a mark-up of the draft technical advice to reflect the points made above.

### **Draft technical advice**

*Proposed new Organisational requirements to be issued under Article 16(3) of MiFID II and/or Provision of Information requirements to be issued under Article 24 of MiFID II*

1. Article 16(3) of MiFID II requires a firm to maintain and operate effective organisational or administrative arrangements, with a view to taking all reasonable steps designed to prevent conflicts of interest (as defined in Article 23 of MiFID II) from adversely affecting the interests of its clients. The potential for conflicts of interest to arise in the underwriting and placing process ~~is significant~~ exists but is made more acute where an investment firm is also mandated to provide corporate finance advice at the same time. ; Therefore, the establishment of organisational arrangements ~~specific to~~ relevant to the provision of corporate finance advice at the same time as the provision of underwriting and placing services by the same investment firm is important.<sup>1</sup>

2. ESMA therefore proposes that the following organisational arrangements and/or provision of information requirements should be placed on firms.

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<sup>1</sup> We agree that conflicts of interest may arise in equity financing transactions. We feel it is important, however, to clarify that the provision of corporate finance advice is separate to the provision of underwriting services.

*Advising to undertake Recommendations in relation to an offering where an investment firm is acting as underwriter only*

3A. The An investment firm acting as an underwriter, before it ~~accepts a mandate to execute a transaction~~ manage the offering, should have arrangements in place to ensure that it explains to the issuer client:

~~i. the various financing alternatives available, and an indication of the level of transaction fees associated with each;~~<sup>3</sup>

ii. the timing and the process the investment firm will take in respect to how it will reach its ~~corporate finance advice~~ recommendations and feedback in respect to pricing the offer;<sup>4</sup>

iii. the timing and the process the investment firm will take in respect to how it will reach its ~~corporate finance advice~~ recommendations and feedback in respect to placing of the offering;

~~iiiv.~~ details of the targeted investors, to whom it is planned to offer the securities; and

~~v. the relevant individuals involved in the production of corporate finance advice on the price and allotment; and~~<sup>5</sup>

ivi. how it intends to manage conflicts of interest that may arise in circumstances where it places the relevant securities with ~~investment clients of the firm~~ investors<sup>6</sup> or with its own proprietary book.

*Advice in relation to an offering where an investment firm is acting as corporate finance adviser and underwriter*<sup>7</sup>

3B. Subject to any changes to the below contractually agreed between the issuer client and the relevant investment firm on a case-by-case basis, the investment firm acting as a corporate finance adviser and underwriter, before it executes the transaction, should have arrangements in place to ensure that it explains to the issuer client:

i. the timing and the process the investment firm will take in respect to how it will reach its corporate finance advice in respect to pricing the offer;

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<sup>2</sup> Requiring the provision by an underwriter of explanations to an issuer client prior to entering into a mandate is impracticable. In practice investment firms will be appointed to an underwriting syndicate through a request for proposal process requiring investment firms to respond to specific fee and other requests from the issuer. Any explanations should be given prior to the execution of the mandate.

<sup>3</sup> We have deleted this limb as inappropriate. An issuer client wishing to engage an underwriter for an initial public offer process or other equity capital markets transaction will already have made a determination on the financing option it wishes to pursue. An investment firm being solely appointed as underwriter will not have the information or time required to undertake a broad survey of financing options available to the issuer client nor will it have been engaged to provide any recommendations in this regard.

<sup>4</sup> In limbs (i), (ii) and (iv), we have clarified that an underwriter will be providing recommendations and feedback to an issuer client and not corporate finance advice. As noted in our response above, giving corporate finance advice is a distinct role that will not have been accepted by an underwriter providing execution services.

<sup>5</sup> As an issuer client is contracting with an investment firm and not with individuals, the identity of specific team members (who may change over the course of a transaction) should not be significant. As such, an obligation to name the individuals who will be involved in working on a particular matter is not appropriate.

<sup>6</sup> The term “investors” is appropriate here, as such investors (whether or not they are clients of the investment firm in other contexts) are not the investment firm’s client in relation to any such placement. The investment firm’s client for these purposes will remain the issuer client.

<sup>7</sup> We have included 3B to cover the obligations of a bank that is providing corporate finance advice as well as underwriting services. We have not included a requirement to explain the various financing alternatives available as the scope of any corporate finance advisory mandate should be left to the parties to determine. If an issuer has already concluded internally that it wishes to pursue an equity capital raise, a bank giving corporate finance advice in that area will not have the information necessary to advise on debt financing options. As a sophisticated counterparty the issuer client should be free to contract for the advice it wishes to pay for and receive.



- ii. the timing and the process the investment firm will take in respect to how it will reach its corporate finance advice in respect to placing of the offering;
- iii. details of the targeted investors, to whom it is planned to offer the securities; and
- iv. how it intends to manage conflicts of interest that may arise in circumstances where it places the relevant securities with investors or with its own proprietary book.

### *Pricing*

4. Investment firms acting as corporate finance adviser and underwriter should have in place systems, controls and procedures to identify and manage the conflicts that arise in relation to ~~possible under-pricing and over-pricing~~ of issues and involvement of relevant parties in this process including 'book building'.<sup>8</sup> Specifically, they should have in place internal arrangements that:

- i. ~~investment firms should have in place internal arrangements that~~ seek to ensure that the pricing of the offer does not improperly promote the interests of other investors clients or, other than prudentially managing its underwriting risk and market reputation, the investment firm's interests, which are distinct from the issuer client's interests;<sup>9</sup> and
- ii. ~~investment firms should have in place internal arrangements that~~ manage ~~or prevent~~ a situation where individuals ordinarily responsible for providing services to the firm's investment clients are involved directly in decisions about corporate finance advice to the issuer client on pricing.<sup>10</sup>

5. In addition, investment firms providing ~~acting as corporate finance adviser~~ and/or acting as underwriter should provide issuer clients with information about how the investment firm ~~determines~~ makes recommendations on the price of the offering and the timings involved.<sup>11</sup> Specifically they should:

- i. ~~investment firms should~~ discuss in general terms with the issuer client any hedging or stabilisation strategies it plans to undertake with respect to the offering, ~~including how these strategies may impact the issuer clients' interests;~~<sup>12</sup> and
- ii. ~~investment firms should~~ take reasonable steps to keep the issuer client informed on developments relevant to the pricing during the offering process.

### *Placing*

6. Investment firms providing corporate finance advice and / or acting as underwriter should have in place internal arrangements that seek to prevent placing recommendations from being ~~inappropriately~~ improperly influenced by any existing or future relationships.

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<sup>8</sup> The reference here should be to pricing of the issue. An issuer client may have objectives other than simply maximising their initial offer proceeds, for example establishing a stable investor base and achieving steady future market price performance. The underwriting banks have no control over an issuer client's priorities or the price of an issue after settlement and cannot and must not control the performance of securities in the aftermarket.

<sup>9</sup> As noted in our response above, as purchaser of last resort an underwriter will always have to have regard to its own risk position. This is part of the arms-length contractual arrangement between the parties.

<sup>10</sup> An underwriter will typically involve senior personnel normally servicing buy-side investors in its consideration of the recommendations to be made to an issuer client on price. The insight provided by such personnel is to the advantage of the issuer client and part of the service that issuer clients would expect a full service investment bank to provide as underwriter.

<sup>11</sup> As noted above, the issuer will determine the price.

<sup>12</sup> It is market practice to discuss stabilisation with an issuer client in advance of the execution of an issue, which will be conducted in accordance with applicable regulations. The banks will not be in a position to determine how such strategies may impact on the issuer client's interests, which must be for the issuer client to determine. Hedging is not commonly undertaken in issuer offerings. To the extent an issuer client has concerns with regard to potential hedging activities then, as noted in the consultation paper, it is open to the parties to agree to restrictions in the underwriting agreement.

7. Investment firms providing corporate finance advice and / or acting as underwriter should have in place internal arrangements ~~that to manage or prevent~~ a situation where individuals ordinarily responsible for providing services to the firm's investment clients are involved directly in decisions about recommendations to the issuer client on allocation.<sup>13</sup>

8. An investment firm providing corporate finance advice and/or acting as underwriter firm must not accept third party payments that are in conflict with the conditions of the inducements regulations in Article 26(b) of the MiFID Implementing Directive. In the context of underwriting and placing, the following practices would be considered abusive (this list is not exhaustive):

i. an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the investment firm ('laddering'). For example, very high rates of commissions paid to the investment firm by an ~~investment client~~investor, or an ~~investment client~~ investor providing very high volumes of business at normal levels of commission as compensation for receiving an allocation of the issue;

ii. an allocation made to a senior executive or a corporate officer of an existing or potential issuer client, in consideration for the future or past award of corporate finance business (spinning); and

iii. an allocation that is expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an ~~investment client~~investor, or any entity of which the investor is a corporate officer.

9. Investment firms acting as underwriter should have in place an allocation policy for clients that sets out the process for developing allocation recommendations. This allocation policy for clients should be ~~provided~~ made available to the issuer client before ~~agreeing to undertake a placing~~execution of a transaction. The policy should set out relevant information (~~to the extent it is known at that stage~~) about the investment firm's ~~proposed~~ allocation methodology ies for the issue.

10. The investment firm acting as underwriter should invite the issuer client to participate in discussions about the placing process so that the investment firm can take the interests of the issuer client into account, ~~for example by obtaining the issuer client's agreement to its proposed allocation policy for the transaction~~.<sup>14</sup>

#### *Retail advice/Distribution<sup>15</sup>*

11. Investment firms should have in place systems, controls and procedures to identify and manage the conflicts that arise where an investment firm provides investment services to ~~an investment client~~retail investment clients to participate in a new issue, where the investment firm is in receipt of commissions/fees from the issuer client in relation to ~~arranging~~ the issuance. Underwriting fees received in such circumstances must comply with Article 26(b) of the MiFID

<sup>13</sup> An underwriting bank will typically involve senior personnel dealing with buy-side investors in its consideration of the recommendations to be made to an issuer client on allocations. The insight provided by such personnel is to the advantage of the issuer client and part of the service that issuer clients would expect a full service investment bank to provide as underwriter. We do not believe that any specific internal arrangements are required to manage this risk as all recommendations will be communicated to the issuer client with the assistance of sell-side personnel, but would welcome any further guidance from ESMA on what it would envisage here.

<sup>14</sup> We agree that issuer clients should participate in discussions on the allocation process so their interests can be taken into account, but suggest this general obligation is sufficient without elaboration. As noted elsewhere in our response, it is now standard for issuers to have significant involvement in the allocation process. To the extent an issuer disagrees with the allocation policy it is open to them to appoint alternative banks or to require through the underwriting agreement that they make the final decision on allocation.

<sup>15</sup> Our changes here are designed to clarify that these requirements should relate only to retail investors and retail distribution. We do not believe that these requirements are necessary in relation to professional investors and would be unduly onerous in such circumstances.

Implementing Directive. This should be documented in the investment firm's conflicts of interest policies, and reflected in the firm's inducement arrangements.

12. Investment firms (and credit institutions) that engage in the placement of financial instruments issued by themselves (or other group entities) to their own [retail investment](#) clients, including their existing [retail](#) depositors ~~clients~~ or investment funds managed by entities of their group, must have in place clear procedures for the identification and management of the potential conflicts of interest that arise in relation to this type of activity. Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients.

13. When disclosure of conflicts of interest is required, investment firms should explain the nature and source of the conflicts of interest inherent to this type of activity, providing [\(subject to any limitations to which the investment firm is subject, such as confidentiality obligations owed to other clients\)](#) details about the ~~specific~~ [specific types of](#) risks related to such practices so as to enable [retail clients investors](#) to make an informed investment decision.

#### *Lending/Provision of credit*

14. In circumstances where any previous [material](#) lending or credit to the issuer client by the investment firm (or a group entity) ~~may~~ [will](#) be repaid with the proceeds of the issue, investment firms should consider whether in such circumstances it would be appropriate to refrain from acting as [sole corporate finance adviser or sole corporate finance adviser and sole underwriter arranger](#) for the securities offering.<sup>16</sup>

15. If the investment firm acted as [sole corporate finance adviser or sole corporate finance adviser and sole underwriter arranger](#) and the steps it took to manage the conflicts of interest were not sufficient to ensure that the risk of damage to the [issuer client or investor](#) would be prevented, the investment firm should disclose to the [issuer client or investor](#) the specific conflicts of interest that have arisen in relation to the activities of the investment firm (or group entity) acting in their capacity as a credit provider, and the activity of the investment firm in acting as [sole corporate finance adviser or sole corporate finance adviser and sole underwriter arranger](#) for the securities offering.

16. Where one entity within a group is acting as a credit provider, and another is acting as [corporate finance adviser or corporate finance adviser and underwriter arranger](#) for a securities offering, the investment firm's conflict of interest policy should require that ~~full~~ [material](#) information should be shared [via appropriate internal channels](#) between the different entities, in relation to the issuer's financial situation.<sup>17</sup>

#### *Record-keeping*

17. Investment firms [acting as corporate finance adviser or corporate finance adviser and underwriter](#) should keep records of the content and timing of [final material](#) instructions received from [an issuer with respect to allocations and investors with respect to book orders](#)~~clients~~. A

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<sup>16</sup> This obligation should apply only where an investment firm is acting as sole corporate finance adviser or sole corporate finance adviser and sole underwriter. Where a syndicate includes one or more investment firms with no such potential conflict of interest, the issuer will be receiving impartial input notwithstanding the fact that it has an existing lending relationship with one investment firm. This follows the approach taken in the US in relation to the use of a "qualified independent underwriter". We have also included a reference to materiality here to align the obligation with the use of proceeds and prospectus disclosure considerations that will apply where an investment firm has an existing lending arrangement with an issuer client. An issuer client will frequently have syndicated debt and, given the broad range of services provided by investment banks, it is possible a number of potential underwriters will have an immaterial exposure to such lending. Where lending is not material and where there is no express intention to repay the lending with the proceeds of the new issue, this should not cause the issuer client's choice of underwriter to be limited.

<sup>17</sup> A reference to material information is less ambiguous here.

record of the final allocation decisions taken for each operation issuer offering should be kept to show ~~provide for a complete audit trail between~~ the movements registered in clients' accounts and the instructions received by the investment firm. In particular, the final allocation made for each client investor should be clearly justified justifiable and recorded. ~~The complete~~ An audit trail of all the material steps in the underwriting and placing process should be made available on request to NCAs.<sup>18</sup>

### *Oversight*

18. Investment firms should have in place an centralised appropriate process to enable them to identify all active potential underwriting and placing operations mandates of the investment firm and keep a record of this information, ~~specifying the date on which the firm was informed of potential underwriting and placing operations.~~<sup>19</sup>

19. The investment firm should have in place a process to identify all potential conflicts of interests arising from the active transactions involving other activities of the investment firm (or its group) which are material; and implement appropriate management procedures to review such potential conflicts. In ~~some exceptional~~ cases, if the conflict of interest cannot be otherwise managed by procedures or arrangements, the investment firm may need to consider whether it should engage in the transaction. ~~only way to manage the conflict would be for the investment firm not to engage in the operation.~~<sup>20</sup>

<ESMA\_QUESTION\_58>

**Q59: Do you consider that investment firms should be required to discuss with the issuer client any hedging strategies they plan to undertake with respect to the offering, including how these strategies may impact the issuer client's interest? If not, please provide your views on possible alternative arrangements. In addition to stabilisation, what other trading strategies might the firm take in connection with the offering that would impact the issuer?**

<ESMA\_QUESTION\_59>

### AFME Response

No. Any requirement to discuss strategies should relate only to stabilisation, which is undertaken to stabilise the price of securities issued in the offering for the benefit of the issuer client and investors, and activities related to stabilisation (such as exercise of an over-allotment option). Stabilisation is carried out in a transparent process in accordance with a Buy-Back and Stabilisation Regulation ((EC) No 2273/2003), and underwriters and issuer clients routinely discuss the process that may be undertaken. Any requirements in this area should clearly distinguish internal hedging. An investment firm will not be in a position to determine how any internal hedging it may undertake may impact an issuer client's interests. Internal hedging should continue to be managed in accordance with the existing conflicts procedures of the

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<sup>18</sup> An obligation to retain details of final instructions and material steps would seem appropriate. We have deleted the reference "to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm" as the requirement was unclear. We feel it is appropriate to require final allocations to be recorded and to require underwriters to be able to justify those allocations if challenged. It is unclear what is expected by an "audit trail of all steps" in the underwriting and placing process. We have suggested clarifying this by reference to "material" steps but would welcome further information on what is envisaged.

<sup>19</sup> We have suggested clarifying that a centralised process of potential underwriting and allotment mandates should relate to "active" mandates, to make clear that no record need be kept where an issuer client has simply been the passive recipient of marketing efforts about possible future issues. In line with the approach taken above, we feel that the general obligation is sufficient here without elaboration.

<sup>20</sup> We have suggested that this requirement should also relate only to active and material transactions of the investment firm, in order to safeguard clients while ensuring the obligation remains manageable.



investment firm and, where requested by the issuer client, limited contractually through hedging restrictions agreed in an underwriting agreement.

<ESMA\_QUESTION\_59>

**Q60: Have you already put in place organisational arrangements that comply with these requirements?**

<ESMA\_QUESTION\_60>

AFME Response

No. While investment firms operate organisational and administrative arrangements to seek to manage conflicts of interests, in our view the draft technical advice would impose unnecessary additional requirements on investment firms. It is in many cases unclear how these changes would materially assist issuer clients or operate in the interests of a fair and functioning market.

<ESMA\_QUESTION\_60>

**Q61: How would you need to change your processes to meet the requirements?**

<ESMA\_QUESTION\_61>

AFME Response

Yes. Certain of the proposed changes would require unwieldy additions to existing processes, which our changes, set out in response to Q.58, are designed to eliminate.

<ESMA\_QUESTION\_61>

**Q62: What costs would you incur in order to meet these requirements?**

<ESMA\_QUESTION\_62>

AFME Response

Yes. As noted above, the draft technical advice would impose additional requirements the benefit of which for issuer clients and the market is unclear. As such the changes we have proposed would maximise benefit to issuer clients and the broader market without incurring unnecessary costs for investment firms or issuer clients.

<ESMA\_QUESTION\_62>

## **2.11. Remuneration**

**Q63: Do you agree with the definition of the scope of the requirements as proposed? If not, why not?**

<ESMA\_QUESTION\_63>

AFME Response

No. AFME broadly agrees with the definition of the scope of the requirements, in that remuneration provisions should apply to all relevant persons who can have a material impact on investment and ancillary services provided by the firm. We would note though that the 'material impact' being referred to here is different from under CRD/AIFMD and UCITS where it is the im-



pact on the risk profile of the firm that is considered rather than solely the impact on the provision of services.

<ESMA\_QUESTION\_63>

**Q64: Do you agree with the proposal with respect to variable remuneration and similar incentives? If not, why not?**

<ESMA\_QUESTION\_64>

#### AFME Response

No. Compliance considerations should be one of the factors but it would not in our view be possible for decisions on compensation to be based mainly on compliance criteria, and we consider that it is important that an adequate distinction is made between the determination of the pool for variable remuneration and the determination of individual rewards. While individual compensation should not be linked on a formulaic basis to financial performance without reference to other factors, ultimately it is a firm's ability to pay and therefore its performance which drives the size of the remuneration pool. The management body of the firm, taking advice from the Human Resources function with input from the compliance and other control functions, might then determine how much individuals received of any pool.

On a more technical level, the wording in the consultation as it is currently drafted does not define the concept of being 'principally based' on compliance criteria which might result in significant variances of interpretation. The sentence "*Remuneration and similar incentives may be partly based on commercial criteria, but should be principally based on criteria reflecting compliance with the applicable regulations, the fair treatment of clients...*" suggests that commercial factors should only play a subordinate role in determining the size of the variable compensation, i.e. less than 50% of total compensation. This contradicts the argument that variable compensation should be able to act as a natural hedge during economic downturns and hence provide stability in regard to a prudential banking point of view. We would also note that the level of an individual's fixed salary over time would also be likely to take account of the extent to which compliance and objectives of fair customer treatment had been met.

From a practical perspective, we would suggest that to the extent appropriate and possible, ESMA's technical advice should be aligned with the recently published ESMA guidelines on remuneration to avoid costs associated with unnecessary further changes.

Finally, while we agree that remuneration practices should not impair client outcomes in the short, medium or long term, the further in time the crystallisation of a poor outcome from the point of sale, the greater will be the difficulty of demonstrating that such a poor outcome was the direct result of a relevant person not taking into account the best interests of a customer.

<ESMA\_QUESTION\_64>

## **2.12. Fair, clear and not misleading information**

**Q65: Do you agree that the information to retail clients should be up-to-date, consistently presented in the same language, and in the same font size in order to be fair, clear and not misleading?**

<ESMA\_QUESTION\_65>

#### AFME Response



No, we do not agree with all elements of ESMA's advice. Whilst we agree with the need for accurate and consistent language and support transparency and consistency in client communications, we believe that the advice provided by ESMA is overly prescriptive, in particular for professional clients. Professional clients have the relevant knowledge and expertise to understand the importance, relevance and completeness of the information presented to them.

We understand that it is ESMA's intention that the requirement for "the same language" to be used in client communications should be interpreted as referring to the "same member state language" e.g. Spanish or French rather than to the same terminology. We think ESMA should make this clearer as there is a risk that this could be interpreted to mean that the same terminology should be used across all client communication media which would not work in practice.

Regarding the local language requirement, we also have some concerns. Whilst standard banking and contractual documentation will be in a language to which a retail client has agreed (the same as basic product documentation), the underlying documentation may not be in the same language, e.g. as regards prospectuses and fund documentation. Certain product requirements such as the Prospectus Directive specifically allow use of different languages in certain circumstances. We understand that it is not the intention of ESMA to override e.g. the provisions of the Prospectus Directive but believe that for the avoidance of doubt this should be made clearer in the advice.

We also note that the local language requirement as currently drafted could be problematic when dealing with clients who are classified as retail only because of a technicality (rather than because they are natural persons of limited experience, for example). In some circumstances retail clients may prefer to receive documentation in more than one language and we would suggest that 2.iii of the Draft technical advice should be reworded as "*shall be consistently presented in the same language throughout all forms of information and marketing materials that are provided to each client, unless the client consents or requests that a different language be used, for example in respect of a specific transaction or set thereof.*"

We also do not believe that there is a need to specify font size. Whilst we agree that information should not be hidden away, this does not necessarily mean it has to be exactly the same font size. It is more important that the size of the important information, statement or warning is proportionate, taking into account the content, size and orientation of the promotional material as a whole and that the disclosure is meaningful and enables the client better to understand the risk. This can be achieved by a number of criteria e.g. text boxes, colours or type faces and above all clarity and simplicity of language. The key concern should be equal prominence, for example a risk warning may be smaller in print but equally prominent through bold print or some of the other criteria mentioned above.

We support the requirement that information is up-to-date and relevant to the method of communication used but as ESMA itself acknowledges there will be time lags which will arise even in the provision of online information. We also note that the requirement for products to be up-to-date should be applied proportionally and not for indefinite periods of time, for instance we would query the extent to which such requirement should apply to old products whose marketing has ceased. We also note that most retail investors buy a product with a view to holding it till maturity.

<ESMA\_QUESTION\_65>

**Q66: Do you agree that the information about future performance should be provided under different performance scenarios in order to illustrate the potential functioning of financial instruments?**

<ESMA\_QUESTION\_66>



### AFME Response

No, we do not agree fully with ESMA's advice. In the first instance, we are not clear what ESMA exactly means by 'different performance scenarios' so further clarification would be helpful.

Overall we believe that obligations relating to describing performance should be interpreted in the light of their purpose and in a way that is appropriate and proportionate, taking into account the recipient, the means of communication and the information the communication is intended to convey. We are generally supportive of information that is based on performance scenarios in different market conditions which reflect the nature and risks of the specific types of instruments included in the analysis. We would encourage ESMA to draw a clear distinction between equities and non-equities instruments as well as giving recognition to the part liquidity will play when reflecting the nature and risks of specific instruments. As previously mentioned we would suggest to restricting this requirement to retail clients who have the greatest need for information.

Given the general regulatory focus on making information materials more accessible and meaningful, we would also ask ESMA to consider whether it would be more appropriate instead to require the marketing party to state the assumptions on which the performance forecast is based together with information about the risks (including negative performance forecasts).

ESMA should consider acknowledging that any such performance scenarios should include appropriate warnings regarding the limitations of the data used and that the scenarios are not equally probable (if appropriate). In order to avoid duplication and potential confusion, this requirement should be aligned with those set out in PRIIPs Regulation which requires appropriate performance scenarios and the assumptions made to produce them.

<ESMA\_QUESTION\_66>

**Q67: Do you agree that the information to professional clients should comply with the proposed conditions in order to be fair, clear and not misleading? Do you consider that the information to professional clients should meet any of the other conditions proposed for retail clients?**

<ESMA\_QUESTION\_67>

### AFME Response

We agree that information to professional clients should be fair, clear and not misleading and that the proposed conditions in paragraph 4 i. and ii. of the draft technical advice are appropriate and adequate in relation to information to professional clients. Regarding 4.iii we would note that the requirement for professional clients to be given information that does not reference potential benefits of an investment service or financial instruments without giving a fair and prominent indication of relevant risks would in some instances appear too restrictive. Whilst in a complete document this requirement seems reasonable, in a "taster" advert or headline directing the reader to further information, this may prove problematic. For example, an internet banner may say "80% capital guaranteed XYZ linked ETF note", then on clicking the banner, the reader will be directed to a fuller description including the fact that capital protection is subject to the credit worthiness of the product issuer.

We do not support, however, that any of the additional conditions proposed for retail clients should also be extended to professional clients. The additional requirements proposed for retail clients on font size, similar language and future performance do not seem necessary for professional clients, given they should have the relevant knowledge and expertise to understand the importance, relevance and completeness of the information presented to them.

We believe serious practical problems are likely to arise if professional clients and eligible counterparties cannot opt out of the disclosure requirements as proposed under section 2.14 (infor-





mation on costs and charges) when the investment products embeds a derivative, which is very common in case e.g. of regular UCITs funds. The term and use of "embed a derivative" should be reviewed by ESMA. As currently proposed, this would force firms to make disclosures to professional clients and eligible counterparties whether they want them or not.

<ESMA\_QUESTION\_67>

### **2.13. Information to clients about investment advice and financial instruments**

**Q68: Do you agree with the objective of the above proposals to clarify the distinction between independent and non-independent advice for investors?**

<ESMA\_QUESTION\_68>

#### AFME Response

No, we do not agree with ESMA's proposals as they are currently drafted. We note that the Level 1 text already prescribes the distinction between independent and non-independent advice which we had not supported given potential negative connotations with non-independent. AFME agrees that investors should have a proper understanding of the basis on which products are sold to them and this includes the nature of the advice provided to them. However, we believe that the ESMA advice is over-prescriptive e.g. by specifying that firms must provide descriptions of the total number of financial instruments and providers analysis per each type of instrument. A firm may adopt a number of tools and strategies to help it advise its clients and manage their portfolios. Based on the ESMA CP analysis 5.ii (page 95) we believe the requirement to inform clients about the selection process adopted should only apply to advice provided on an independent basis but this is not clear from the wording of paragraph 4 of the advice.

Also, the prescriptive information required regarding number of products/providers and proportion of products provided through "close links" is unlikely to be static and could become out-of-date quickly. If disclosure of this information is required, we suggest that a more general explanation of the types of products offered and possibility of close links would be more useful to clients than numerical figures.

We also note that Level 1 makes no distinction between retail and professional clients, whereas in jurisdictions where similar advice models have been applied the focus has been on retail clients, an approach with which we agree. ESMA should further consider how to reflect this very important distinction in its advice.

AFME believes that a clear distinction needs to be made between retail and professional clients. This differentiation as already provided in MiFID 1 should be maintained in particular also in relation to information to be provided on investment advice and financial instruments. As outlined above, professional clients and eligible counterparties should have the possibility to opt out of information requirements. The vast majority of these clients and counterparties will not be remotely interested in this level of detailed information and hence a substantial burden will be created for the entire industry with no real benefit, but added cost ultimately for the end user (see also response to Q 67).

In particular, as regards professional clients, we believe it is disproportionate to have to disclose any instance of advice being provided as independent or non-independent. Firms that may provide advice to professional clients throughout their course of business should be able to inform

the professional client at the outset of the relationship or on a periodic basis what type of advice (independent or not) will be provided.

Furthermore, we consider it disproportionate in relation to professional clients to have to specify why a firm is not independent and effectively how "non-independent" the advice is by virtue of all the disclosures around close-links etc. It can and must be expected from professional clients that they would ask the firm for such information should they want it.

<ESMA\_QUESTION\_68>

**Q69: Do you agree with the proposal to further specify information provided to clients about financial instruments and their risks?**

<ESMA\_QUESTION\_69>

AFME response

No, we do not agree. Overall we support clients being provided with transparent information about their financial instruments. However, such requirements must be applied taking into account the nature of the client. Quality and usefulness of information is more important than quantity. We agree that it is important that such information can be provided in a standardised format such as product fact sheets. Particularly in respect of professional clients, the requirement to be clear, fair and not misleading (which we support) should already cover their information requirements. Professional clients have the knowledge and experience to make their own decisions and have the power and sophistication to ask for any additional information if they want and require it. It would not be proportionate to expect a firm to provide this information on a regular or frequent basis to professional clients who understand the markets in which they operate.

Furthermore, we have the following detailed remarks regarding ESMA's advice on Information about financial instruments:

- Paragraph 8 (Scenarios): Whilst we agree with the provision of information on the functioning and performance scenarios of the financial instrument in different market conditions, it should be specified that general scenarios are acceptable with no need to adapt to the specific amount bought by a particular client.
- Paragraph 9 (Illiquidity): The investment firm should not try to estimate a time frame for the sale of illiquid financial instruments as this could result in client expectations not being fulfilled. It should be sufficient to inform the client what illiquidity means. Additionally, in the case of disinvestment, an estimate of the time frame for the sale of a financial instrument is not possible as it will depend on the specific conditions at the time of disinvestment (e.g. market conditions, market liquidity, client's interest to sell under certain price conditions, etc.), which are difficult to estimate ex-ante. Therefore we suggest removing this provision.
- Paragraph 10 (financial instrument composition): It would be helpful if ESMA could clarify what it means by "status of the financial instruments".
- Paragraph 12 (fact sheet): According to Recital 84 of MiFID 2, "(...) nothing in this Directive obliges firms to provide it (information about the investment firms, financial instruments, costs and expenses, etc) either separately or by incorporating the information in a client agreement." In order to be consistent with that wording, a reference to the contract should be added to subparagraph 12, which could read as follows:

*"Information on financial instrument may be provided in a standard format such as a product factsheet or as part of or an annex to the contract."*

Finally, we note that that existing or proposed European legislation already provides for information regimes for certain investment products (such as key information document requirements under UCITS and PRIIPs), therefore the MiFID 2 requirements should not overlap.

If existing or proposed European legislation does not require similar information to be provided on a particular investment, we suggest that such information should be provided to clients in advance (potentially in the form of a “product book”, setting out the usual features and risks of investments). This can be supplemented on a trade-by-trade basis with additional disclosure (e.g., if there is a specific guarantee in place for the investment), although providing additional trade-by-trade disclosure would not be necessary if the key risks and features of the investment was already covered by the “product book” (for example, vanilla bonds and equities). We think this would result in meaningful product disclosure being provided to clients without resulting in clients receiving excessive amounts of paperwork and disclosures when they decide to trade.

<ESMA\_QUESTION\_69>

**Q70: Do you consider that, in addition to the information requirements suggested in this CP (including information on investment advice, financial instruments, costs and charges and safeguarding of client assets), further improvements to the information requirements in other areas should be proposed? If yes, please specify, by making reference to existing requirements in the MiFID Implementing directive.**

<ESMA\_QUESTION\_70>

#### AFME Response

No, we believe that the information requirements are already very extensive and no additional information is required.

<ESMA\_QUESTION\_70>

## **2.14. Information to clients on costs and charges**

**Q71: Do you agree with the proposal to fully apply requirements on information to clients on costs and charges to professional clients and eligible counterparties and to allow these clients to opt-out from the application of these requirements in certain circumstances?**

<ESMA\_QUESTION\_71>

#### AFME Response

No, do we not agree with ESMA’s current advice. We believe that the full range of requirements should not apply to professional clients and eligible counterparties. The opt-out ESMA suggests is too limited in scope. Firms should be able to agree a limited application of these requirements in **all** situations where investment services are provided to professional clients and eligible counterparties (and in the specific context of corporate finance business which sometimes involves the provision of investment advice to entities that are, for purely technical reasons, retail clients).

With regard to the removal of the possibility to opt-out of information whenever the service includes a derivative, ESMA’s advice appears to confuse the need for transparency on costs and charges with the judgement on the complexity and risk. We therefore find that the inclusion of the derivative instrument criterion as a limitation for the opt-out is conceptually flawed, also because it does not appreciate situations when derivatives (such as FX) are merely connected to the provision of other investment services, and are as such only an ancillary service (see MiFID

Annex I Section B "Ancillary services"). This is particularly the case for global custodians who offer foreign exchange and interest rate contracts to their clients in order to be able to service their assets across different jurisdictions.

It is also not clear to us how the opt-out would work in practice. For example it would be important that such opt-out could be confirmed on a one-off basis via standard terms and conditions.

We would also suggest that there should be some flexibility to provide information to professional clients in the format best suited to their needs.

<ESMA\_QUESTION\_71>

**Q72: Do you agree with the scope of the point of sale information requirements?**

<ESMA\_QUESTION\_72>

AFME Response

No, we do not agree: we believe they are too wide especially for professionals and eligible counterparties.

<ESMA\_QUESTION\_72>

**Q73: Do you agree that post-sale information should be provided where the investment firm has established a continuing relationship with the client?**

<ESMA\_QUESTION\_73>

AFME Response

No, we do not agree with the meaning of “continuing relationship” in terms of execution arrangements which apply only to “one-off” investment services, thus implying that e.g. providing an ‘execution-only service’ more than once would automatically result in a continuing relationship with the client. Other factors such as the amount of business conducted may also be relevant in order to establish the nature of such a client relationship. It would appear that applying the meaning of ongoing relationship narrowly could result in new system requirements (with resulting costs) to flag subsequent transactions. In order to overcome such operational challenges some firms may simply choose to classify all relationships as “continuing”.

<ESMA\_QUESTION\_73>

**Q74: Do you agree with the proposed costs and charges to be disclosed to clients, as listed in the Annex to this chapter? If not please state your reasons, including describing any other cost or charges that should be included.**

<ESMA\_QUESTION\_74>

AFME Response

No, we do not agree with the proposals, particularly where transactions involve Eligible Counterparties as it is difficult to establish in such circumstances who provides services to whom. In such instances, information should be made available on request. There appears to be confusion between permissible fees and charges such as custody with inducements. There could also be unintended consequences from firms having to formally appoint all third party service providers in order to achieve the required transparency.

We are also not clear what is meant by “mark ups embedded in the transaction price” (example provided in Annex 2.14.1 on costs related to transactions initiated in the course of the provision of an investment service). The technical advice should take into account the distinction between price and costs. We do not believe that margin and bid-offer spread should be disclosed which would also potentially confer a competitive advantage to non-MiFID firms. If ESMA feels that further disclosure of margins is essential then this should only be provided as an issuer’s estimated value and only in an aggregate amount of costs and charges.

<ESMA\_QUESTION\_74>

**Q75: Do you agree that the point of sale information on costs and charges could be provided on a generic basis? If not, please explain your response.**

<ESMA\_QUESTION\_75>

AFME Response

Yes, we agree that this information can be provided on a generic basis. It would be economically and logistically unfeasible and of limited benefit to the client to provide this information on any other basis. It is unclear to our members how such information, given the practicalities surrounding such provision, could be provided on a personalised basis.

We would also suggest that point of sale information on costs and charges could be provided on a more generic basis in relation to service costs as well (not just in relation to the financial instrument in question). There will be cases where providing specific personalised service costs in the manner suggested by ESMA may be misleading or impractical for many firms (given the possible technology and operational builds to provide pre-sale transaction specific disclosures). For example, monetary values for management fees or other ongoing charges that are usually expressed as a percentage of assets under management could be unhelpful to clients as the actual fee charged (often charged in arrears on a periodic basis) could fluctuate from the point of sale disclosure as a result of market value movements. Similarly, transaction fees that are expressed as a percentage of the nominal value of the investment made would need to be disclosed repeatedly each time the client changes their order. Clients may also find the amount of pre-sale disclosure to be unhelpful, especially clients that transact on a frequent basis. Effective costs disclosure could be achieved where clients are given clear disclosure regarding the type of costs charged, the basis for calculation (so client can verify the charges levied) and detailed post-sale disclosure that is presented in line with the pre-sale generic costs and charges information.

At the very least, clients should be given the option of choosing the “generic” model of disclosure if it best suits them or where it may be more appropriate given the client’s trading volume or the firm’s own charging structure.

<ESMA\_QUESTION\_75>

**Q76: Do you have any other comments on the methodology for calculating the point of sale figures?**

<ESMA\_QUESTION\_76>

AFME Response

We note that the methodology for calculating the point of sales figures is the remit of Article 8(5)(c) of the PRIIP KID Regulation, MiFID Level 2 and PRIIP disclosures should be aligned.

In situations where investment and/or ancillary services are provided without the sale of a financial instrument or a structured product, there is no underlying investment value. In such a case,



a representation of the total aggregate costs as a percentage cannot be made and ESMA should recognise this in its advice.

<ESMA\_QUESTION\_76>

**Q77: Do you have any comments on the requirements around illustrating the cumulative effect of costs and charges?**

<ESMA\_QUESTION\_77>

#### AFME Response

We are concerned that the technology to aggregate all costs and charges on an annual basis may currently not exist. For example, we are aware of significant practical issues arising from Dodd-Frank requirements for firms to be able to search transaction records on a per client basis.

Even if the technology issues could be addressed by the time MiFID 2 is implemented, we are concerned about the impacts this may have on cost and charges for clients.

We would also suggest that these obligations are not necessarily appropriate for certain financial instruments. For example, the return on a bond or share is entirely determined by the market and a client pays any fees and charges for that transaction as a separate matter (often as a one-off charge, such as an execution cost). It therefore may not be suitable for a firm to provide cumulative impact illustrations in respect of certain investments that are not “manufactured” (such as shares and bonds) and it may be worth reviewing the product scope for this requirement (i.e., limiting to products in scope for PRIIPs and KIIDs requirements, that already provide information on product costs and charges).

<ESMA\_QUESTION\_77>

**Q78: What costs would you incur in order to meet these requirements?**

<ESMA\_QUESTION\_78>

#### AFME Response

We believe that additional costs would arise from these proposals but are not yet in a position to provide specific estimates.

<ESMA\_QUESTION\_78>

## **2.15. The legitimacy of inducements to be paid to/by a third person**

**Q79: Do you agree with the proposed exhaustive list of minor non-monetary benefits that are acceptable? Should any other benefits be included on the list? If so, please explain.**

<ESMA\_QUESTION\_79>

#### AFME Response

No, AFME disagrees with the decision to determine an exhaustive list of minor non-monetary benefits.

Article 24(13)(d) of MiFID II empowers the Commission to adopt delegated acts that include “the criteria to assess compliance of firms receiving inducements with the obligation to act honestly, fairly and professionally in accordance with the best interest of the client”. The mandate,

therefore, only extends to the stipulation of criteria, which by definition are discriminating factors used to determine whether a particular item belongs to a category. The Commission is not empowered to offer a definitive list of all the items that belong to the category, and to do so would inappropriately extend the application of the inducements prohibition beyond what was intended by Level 1 of MiFID II. Moreover, determining a full list of all the components of a category restricts it to what is known at the time of drafting, therefore increasing the potential for a regulatory vacuum over time.

AFME supports the idea of clear rules on inducements, with a view both to increasing transparency for end investors and to facilitating effective conflicts management by portfolio managers. However, the provision of investment research is not an inducement.

#### Research is a service that is charged and paid for

The discussion of minor non-monetary benefits in chapter 2.15 of the Consultation Paper seems predicated on the assumption that investment research is a benefit, and therefore an inducement that portfolio managers are barred from receiving except when it is of a minor nature. We fundamentally disagree with this view.

The provision of investment research, as a matter of law, is a service; it is explicitly included as such in Annex I of MiFID II. Provision of research by a MiFID firm also requires that the recipient becomes a client of the research provider (art. 4(9) MiFID II). In that respect, it is no different from other investment services, which are purchased by the portfolio manager on behalf of its funds, for the benefit of the underlying asset owner.

The prohibition on receipt of non-monetary benefits cannot be interpreted as a prohibition for the receipt of investment services, activities or ancillary services (as defined in Sections A and B of Annex I of MiFID II) when those services are paid for at arm's length and for full value.

#### Portfolio managers may purchase research from brokers at arm's length and for full value

As paragraph 15 of ESMA's introduction to the draft technical advice correctly identifies, the prohibition on the receipt of non-minor inducements does not prohibit portfolio managers from purchasing research directly on behalf of their client from a broker or a third party, as long as there is a clear and separate contractual agreement between themselves and the broker or third party. We support this view and would suggest that this be clearly stated in the draft technical advice (please see suggested drafting below). As outlined below, we propose that this could be achieved via the widespread adoption of Commission Sharing Agreements (CSAs), combined with contracts for provision of research explaining the basis on which expenditure will be made.

As for other services, the portfolio manager may arrange for a fund to purchase the service and the fund will then consume the service and benefit from it via the portfolio manager; this is a practical necessity given the fact that the fund itself is a legal construct with no personnel, so has to rely on the portfolio manager to avail itself of the service.

AFME agrees with ESMA that, as for other services, the portfolio manager or independent adviser would need to ensure that the terms of such arrangements are not influenced by other services they acquire directly on behalf of their clients from the same third party, and would be subject to all other conduct of business rules, for example on the management of conflicts of interest.

As some European regulators have noted, current market best-practice arrangements for paying for research in some countries (the UK, France and several other EU member states) provide a cost-effective and transparent mechanism, utilising CSAs, to satisfy the requirements in this section. We explain how these work below. With the improvements that we suggest, we are confident that, if similar arrangements were recommended or made mandatory by regulators

across Europe, the policy objective of separating decisions and payments regarding execution from decisions and payments regarding research could be achieved in a way that maximises benefit and minimises costs for end investors in the funds that are the portfolio managers' clients.

ESMA's contention that when research is provided at an undervalue it may be an inducement and if so can only be received by a portfolio manager if it is a minor non-monetary benefit.

When the portfolio manager avails itself of materials that are generally available then the materials are not capable of being an inducement, because there is no link between the availability of the materials and the purchase of other services from the research provider.

There is a third, theoretical possibility which we should deal with, which is that when research that is not generally available is provided at an undervalue, then it could be an inducement and, therefore, portfolio managers would only be able to receive it when it is a minor non-monetary benefit.

Minor non-monetary benefits must be:

- capable of enhancing the quality of service provided to a client; and
- of a scale and nature that could not be judged to impair compliance with the portfolio manager's duty to act in the best interest of its clients.

This will depend on the circumstances in each case, so we consider it helpful that ESMA decided to include financial research in its list of minor non-monetary benefits and would suggest that, in the interests of clarity, it be separated from information on financial instruments. The current drafting could be read to mean that only single-instrument research is capable of being a minor non-monetary benefit. It is difficult to see the rationale for singling this out; depending on the investment objectives of the fund on whose behalf the manager consumes the research, general economic research or sectoral research could be just as capable of enhancing the service received by the fund as could single-instrument research.

#### Quality enhancement

In relation to the quality enhancement requirements, we agree that an investment firm cannot purport to receive a benefit from a third party as a permissible inducement, if that benefit is a service that the investment firm itself was expected to perform. It is important, however, to differentiate between core and non-core services, which appears also to be supported by ESMA in the use of the word "essential" in the draft technical advice paragraph 10(i). Clarifying therefore that ancillary services are non-essential would be a useful enhancement to the proposed technical advice, and we provide a drafting suggestion in our response to question 81.

#### Amendments to the proposed technical advice

##### *Accept and not retain third party payments*

[...]

3. Investment firms providing the service of independent investment advice and portfolio management are not allowed to receive non-monetary benefits that do not qualify as minor. In this context, a non-monetary benefit is any service received for free or at an undervalue by the investment firm which provides the service of independent investment advice and portfolio management. Non-monetary benefits do not include any services or activities in Sections A and B of Annex I of Directive 2014/65/EU which are received and paid for at arm's length by the investment firm on its own behalf or on behalf of its clients, whether through dealing commissions or out of the investment firm's own resources.



### *Minor non-monetary benefits*

4. ESMA advises the Commission to introduce an non-exhaustive list of non-monetary benefits that can be considered to be minor and are therefore acceptable. All such benefits should only qualify as minor when they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipient's behaviour in any way that is detrimental to the interests of the relevant client.

5. This list should include the following benefits:

i. Information or documentation relating to a financial instrument (~~including financial research~~) or an investment service; ~~This information could be generic in nature or personalised to reflect the circumstances of an individual client;~~

ii. financial research (including research on financial instruments or issuers, as well as sectoral and economic research);

iii. participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; and

iiii. hospitality of a reasonable de minimis value, this could for example include food and drink during a business meeting or a conference, seminar or other training events mentioned under iii.

6a. Minor non-monetary benefits as defined above should be clearly disclosed by investment firms before providing investment or ancillary services to clients.

6b. Material that is generally available to all without a fee, for example a free broadcast or an article published on a website that is free to access, is not capable of being an inducement.

6c. For the avoidance of doubt, it should be clear that the prohibition on the receipt of non-minor inducements does not prohibit portfolio managers, whether acting for themselves or on behalf of their clients (i.e. the funds they manage) from purchasing goods and services, including research, from a broker or a third party as long as there is a clear and separate arm's length contractual agreement between themselves and the broker or third party.

### *Example of arrangements where research is paid for at full value and at arm's length*

Any proposed solution must address the objective stated by ESMA in paragraph 2.15 "The portfolio manager or independent adviser would need to ensure that the terms of such arrangements with a third party are not influenced by other services they acquire directly on behalf of their clients in their provision of independent investment advice or portfolio management services where they acquire these from the same third party."

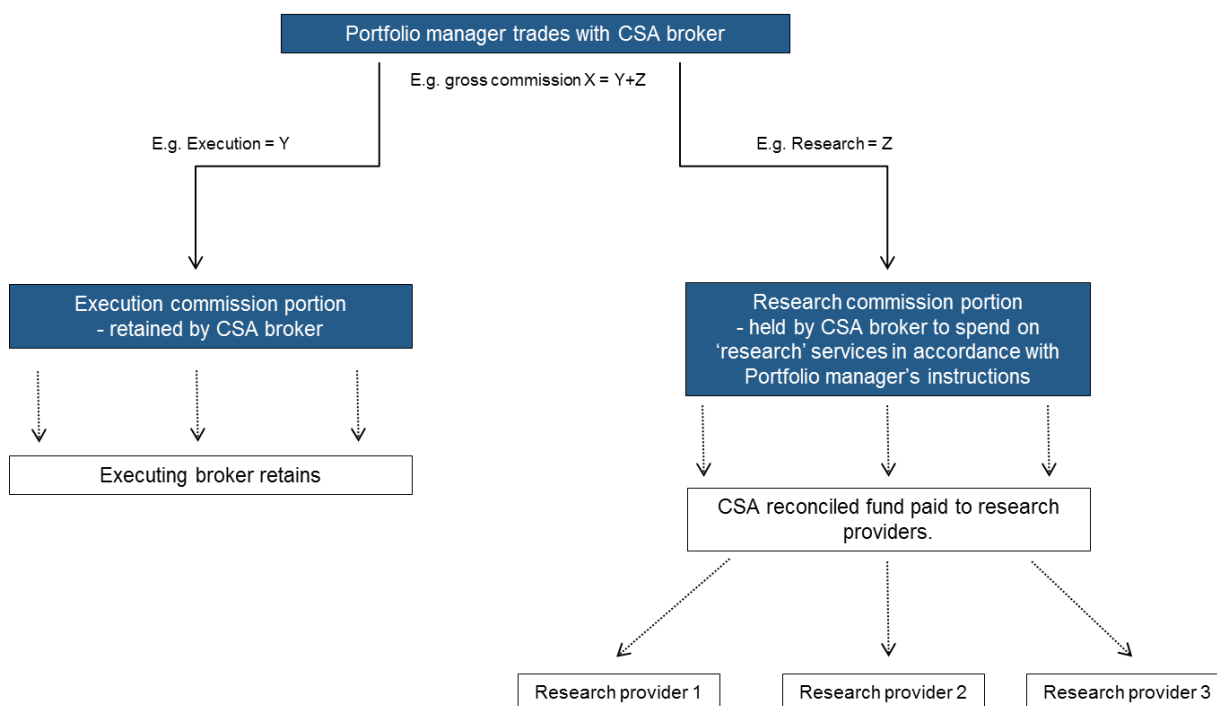
The amendments to the draft technical advice that we have proposed and the objective of paragraph 15 would be satisfied through the establishment of a mechanism for receipt and payment for research which consists of:

- (i) CSAs for portfolio managers signed with executing brokers; combined with
- (ii) ex-ante contracts between managers and research providers covering the provision of research services (including generic methodology where such is paid for on an ex-post basis).

This mechanism allows the portfolio manager completely to disaggregate the decision as to where to purchase execution, from the decision where to purchase research. It also provides transparency and complies with the requirement to disclose the price of separate services that are provided together by the same investment firm (Art. 24(11) MiFID II). It is important to note that the portfolio manager is not required to purchase research services from the broker it uses for execution services. The portfolio manager can use the commission credits it has accrued to purchase research services from any of the research providers, and can indeed decide to stop paying the research portion of the commission once it considers it has accumulated a sufficient amount of research credits for the period in question.

We have provided below an explanation of the CSA model which is currently widely used by the majority of major European portfolio managers.

### Current CSA Model

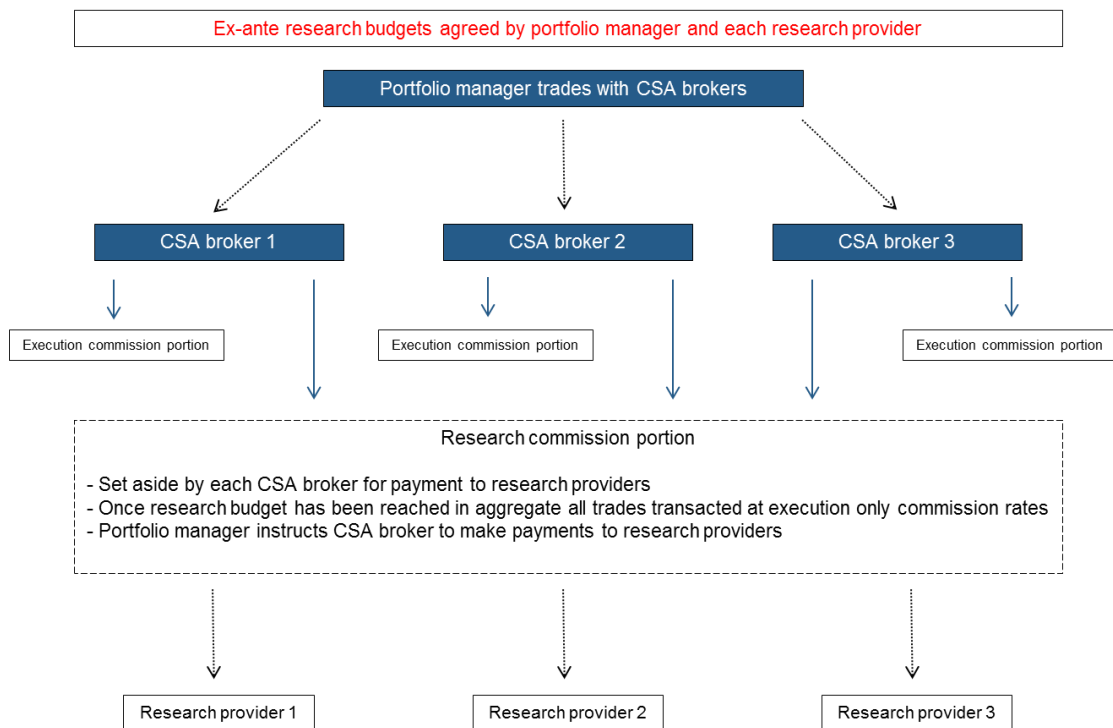


1. Portfolio manager trades with executing broker on behalf of fund. The choice of executing brokers may differ from the choice of research providers. Executing brokers are chosen by portfolio managers on the basis of criteria relevant for best execution, whereas research providers would be chosen on the quality of their research.
2. Fund (acting via the portfolio manager) pays a gross commission rate to the executing broker, the portfolio manager stipulating clearly which portion of that commission is for execution services and which is to be set aside for the payment of research providers.
3. Once the research budget is reached in aggregate across the CSA accounts, all subsequent trades are transacted at execution-only rates.

4. Payment for research services is determined by portfolio managers on the basis of the quality of research service they have received. The portfolio manager instructs the CSA broker on a regular basis (e.g. quarterly, semi-annually) to make payments to the research providers. One way in which this happens currently is based on a broker vote, which ranks the quality of research provided to the portfolio manager.

To improve current practice further, and also to provide greater transparency, we would propose the use of ex-ante contracts for the generic provision of research between portfolio managers and research providers, as described above. This is in line with paragraph 15 and, when the research provider is a broker, also complies with the requirement to disclose the price of separate services that are provided as a combination by the broker (MiFID II Article 24(11)). We show the proposed enhancement in the diagram below.

Proposed Enhanced CSA Model



<ESMA\_QUESTION\_79>

**Q80: Do you agree with the proposed approach for the disclosure of monetary and non-monetary benefits, in relation to investment services other than portfolio management and advice on an independent basis?**

<ESMA\_QUESTION\_80>

AFME Response

No.

Our general views apply, expressed throughout our response to this CP, as to the need for meaningful disclosure as opposed to tick-box disclosure. Therefore, to allow firms and their clients to focus attention and resources on inducements that are likely to be relevant to the decision-

making process, we would suggest that minor non-monetary benefits be disclosed in a summary manner and they similarly be recorded in a summary manner in the inducements register described at paragraph 13.

We can also see competition law issues here if large banks are required reciprocally to disclose detailed cost and fee arrangements to each other, when it is not clear which is the service provider.

<ESMA\_QUESTION\_80>

**Q81: Do you agree with the non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met? If not, please explain and provide examples of circumstances and situations where you believe the enhancement test is met. Should any other circumstances and/or situations be included in the list? If so, please explain.**

<ESMA\_QUESTION\_81>

AFME Response

No.

We do believe that a non-exhaustive list of positive indicators of quality enhancement would be more compliant with Level 1, as the requirement in Article 24(13)(d) is for the Commission to provide criteria to assess compliance with the inducements prohibition, not non-compliance. We would therefore suggest removing paragraph 11 and redrafting paragraph 10 as follows:

“A fee, commission or non-monetary benefit will generally be regarded as designed to enhance the quality of the relevant service if it has one or more of the following characteristics:

- i. It is used by the recipient firm to provide for an additional or higher quality service to the end client that goes beyond the relevant minimum regulatory requirements (including any ancillary services in Section B of Annex I which are non-essential for the provision of the investment services and activities of Section A of Annex I of MIFID II);
- ii. It is used by the recipient firm to provide goods or services that extend its offering beyond what it would be expected to provide in the ordinary course of business;
- iii. It delivers value or a tangible benefit to end users and clients of the recipient firm;
- iv. It enables the end user to access a wider range of financial instruments or services that would otherwise be available, for example by enabling the provision of non-independent advice on an ongoing basis, so long as any such service or instrument is provided without bias or distortion as a result of the fee, commission or non-monetary benefit being received.

ESMA may also add to these characteristics by developing ESMA guidelines and recommendations.”

<ESMA\_QUESTION\_81>

**Q82: Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.**

<ESMA\_QUESTION\_82>

Yes. AFME anticipates that there would be substantial additional costs in order to comply with the proposed requirements.

If research cannot be paid for via dealing commissions, we expect there would be significant and negative consequences on fund interests and returns. Research services constitute valuable services to portfolio managers and funds, because they enable portfolio managers to make better investment decisions, which ultimately benefit the fund. If research cannot be paid for via dealing commissions, there will be substantial international divergence as to how research costs are charged and disclosed in the EU to the detriment of European portfolio managers, whose annual management charges will be inflated compared to non-EU portfolio managers, hence adversely biasing the comparability of their services' costs and accordingly affecting consumer investment decision and choice.

The portfolio manager would need to find an alternative way of paying for research services. This could include one or more of:

- a. increasing its management fees to cover the costs;
- b. paying for research via its own operating expenses; or
- c. charging funds separately for research.

Some of the potential costs and detrimental consequences to funds are outlined below.

*Competitive advantage to non-European portfolio managers*

Given that research is an essential service assisting portfolio managers in the performance of their core function and that research, like execution, is a service used for the benefit of the fund rather than the portfolio manager, the cost of research is likely to be passed on to funds, probably through the annual management charge (AMC).



Analysis of the UK market suggests that the increase in the AMC arising from incorporating the cost of research could be in the region of 7bps, rising to 9bps if research payments are subject to VAT (which is likely to be charged on explicit separate payments for research, at least in some jurisdictions, including the UK, in a way that dealing commissions are not)<sup>21</sup>. This figure is based on the AMC increase being the same as an implied research payment of £1.04bn (£1.25bn with VAT) divided by the estimated active equity mandate assets under management (AUM) of £1,463bn. A worked calculation is below:

|  |                               |  |
|--|-------------------------------|--|
| AUM (end 2012)                               | £4,459 bn                     | (IMA Annual Survey 2012-3)                               |
| Equity content                               | 42%                           | (IMA Annual Survey 2012-3)                               |
| Implied equity assets                        | £1,873 bn                     |  |
| Active                                       | 78%                           | (IMA Annual Survey 2012-3)                               |
| Active equity AUM                            | £1,463 bn                     |  |
| Turnover                                     | 1.2x                          |  |
| Commission rate                              | 11bps                         | (Greenwich Associates<br>European Equity Investors 2013) |
| Implied commissions                          | £1.93 bn                      |  |
| Research allocation                          | 54%                           | (Greenwich Associates<br>European Equity Investors 2013) |
| Implied research payment/<br>increased AMC   | £1.04 bn, or 7bps on £1,463bn |  |
| VAT on which @ 20%                           | £0.21 bn                      |  |
| Total implied research payment/increased AMC | £1.25 bn, or 9bps on £1,463bn |  |

In theory, the impact of moving research costs from dealing commission to AMC should be neutral to the end investor. But investors, and retail investors in particular, focus on AMCs when comparing relative costs of portfolio managers and often use these as the key point of comparison between portfolio managers. As a result, it would appear to investors that a European portfolio manager running an identical fund to a US portfolio manager is charging a higher AMC, thus placing European portfolio managers at a competitive disadvantage. Furthermore, the gap in AMCs charged by actively-managed funds would widen as compared with passively-managed funds.

Given that investors are naturally very focused on driving costs down (and in some cases have a fiduciary or legal duty to demonstrate such a focus on costs) there would be a strong incentive to switch their funds away from European portfolio managers to US portfolio managers, where the management fees are likely to be lower.

There would also no longer be a common point of comparison between the relative costs of portfolio managers on a global basis; European portfolio managers' costs methodologies will be out

<sup>21</sup> BofA Merrill Lynch global research, "Commission Unbundling – the European Dimension", 12 June 2014.

of step with the way the rest of the world both charges and discloses costs. Given that this will be a competitive advantage to non-European portfolio managers, there will be little incentive for non-European jurisdictions to change their regulatory regimes so that they are in line with that of Europe. There has so far been no indication that other jurisdictions are considering changing the way that their portfolio managers pay for research, and we note that such change would require significant political motivation to do so given that it would require legislative change in, eg, the US.

This will make it difficult for European portfolio managers to compete in the international marketplace, particularly for international mandates, and would likely result in a reduced choice of funds and portfolio managers available to the European consumer. Portfolio managers that manage products out of both the Europe and the US will likely move operations to the US, given the competitive advantage of doing so. EU-managed products may also be less attractive to US consumers, as a consequence of higher headline costs.

#### *Disproportionate impact on smaller portfolio managers*

The current system has low barriers to entry for new/small portfolio managers. By contrast, ESMA's proposals would erect considerable barriers to entry in the form of the high start-up costs which would result from paying for research out of profit and loss.

The combined effect of raising barriers to entry for smaller portfolio managers, and of encouraging funds (including very large pension funds and sovereign wealth funds) to switch their funds to non-EU portfolio managers to avoid apparently higher fund management fees, is likely to have a materially detrimental impact on investment within the EU and consequently upon economic growth in the region, as well as reducing customer choice.

#### *Increased operating costs for portfolio managers*

An alternative to passing on costs of research in the AMC would be for portfolio managers to absorb the research costs into their own operating costs. Based on the analysis referred to above, this could represent between 30-40% of operating margins<sup>22</sup>. Whilst large portfolio managers might be able to absorb these costs, and global portfolio managers might be able to restructure their businesses to minimise the impact, smaller European portfolio managers would be less able to absorb the cost. This would mean that they might have to reduce the levels of research consumed, to the detriment of end- investors or, in extreme circumstances, cease business thus reducing consumer choice. This could result in a contraction to the European investment management industry; it could also encourage capacity to move to the rest of the world, which would enjoy relatively higher operating margins.

Imposing high fixed costs on European regulated portfolio managers would increase their operational leverage relative to non-EU peers and make them more vulnerable to the effects of any future economic downturn, creating additional risks for funds managed by European portfolio managers, risks that investors in funds outside the EU would not face.

#### *Fewer smaller independent research providers*

One consequence of a potentially reduced funding pool from European portfolio managers for research services would be less independent research content and diversity, as a result of broker consolidation. Smaller boutiques would struggle to sustain their business models as portfolio managers, facing increasing pressure to cut their costs, further seek to consolidate their research and execution broker lists.

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<sup>22</sup> BofA Merrill Lynch Global Research, *ibid*.

### Less diverse research coverage

Service providers may choose to restructure their businesses and concentrate resources on the production of research on blue chip companies, as opposed to small and medium enterprises. This could potentially result in less unique and contrarian research being produced, whilst leading to a reduction of the coverage universe. This reduction of coverage would result in a less well informed market and could ultimately impact small and medium European enterprises as they seek to grow through raising capital; less research coverage is in turn likely to result in less investment in these enterprises by European portfolio managers.

A similar effect is likely to be seen on emerging markets research. Both small/medium-sized enterprise (SME) coverage and emerging markets research coverage tend to be provided by specialist/local analysts. A move in the market to favour larger research providers, which are able better to absorb the increased operating costs, would see fewer small independent research providers covering these areas, which will likely be considered unprofitable.

Due to the cyclical nature of sectors and geographical regions, firms currently maintain a service covering of areas that may not at a specific point in time (for example in a downturn) be a key area for investment by portfolio managers. However, the advantage of maintaining consistent coverage in these areas for the end investor is that when the area in question does become a viable investment opportunity then there is still valuable research and expertise available. Under the new proposals, research providers would be less able and less likely to maintain continuous coverage and due to the nature of research production (expertise is built up over a period of time as opposed to acquired instantaneously) are unlikely to be able to suddenly cover such areas.

Removal of incentives to improve the quality of advisory resources (as a consequence of the reduction in the open, competitive nature of the market for research advice) would also result in a lower quality of research available to portfolio managers, and ultimately lead to less well-considered investment decisions for investors.

### Procurement of US research

European portfolio managers and their clients will be disadvantaged relative to portfolio managers and clients in other jurisdictions because US brokers may refuse to provide them with bespoke or other valuable research in exchange for cash payments. This is because of uncertainties under US investment adviser law when so doing. While some major US broker-dealers are also registered as investment advisors, their research analysts are not considered investment advisors. Though the SEC staff has provided limited no-action relief in this area, the relief is unworkable given practical realities. As a result of these regulatory concerns, most major US brokers do not generally accept cash payments for research. Even if US brokers were willing to accept cash payments and submit to investment advisor regulation over their research, US laws governing investment advisers would result in these brokers limiting their transactions with European portfolio managers and their clients to agency transactions. This would deprive European investment managers and their clients of capital commitment, volume-weighted average price (VWAP) and other transactions effected on a principal basis via a broker providing the research, and also of investments sold on a dealer-only basis, thus forcing those European managers and their clients into the possibly less favourable agency markets for those investments and, therefore, potentially jeopardising best execution.

If European portfolio managers could not pay for US research from commission due to a prohibition under European regulation, and US broker/dealers could not in practice accept payments for research under US law, this would make it impossible for a European-based investment manager to procure US research, which in turn could result in European portfolio managers being unable to procure US research other than from registered investment advisers or European



producers of US research. This could lead to a significant reduction in choice of the research being procured on behalf of the end investor.

This would also make it less economically viable for European firms to publish research on US companies or macro-economics; meaning less US research, at higher costs, for European consumers and potentially poorer performance for European portfolio managers managing US assets. As a consequence, it would be more difficult for European investors to access US markets, given that European portfolio managers will reduce US mandates under management. European consumers will be left with less choice of funds providing exposure to US markets, and with higher risk, as most of the investment options available will be managed by US managers, thus leaving those European consumers without the protection of the European regulatory regime.

#### Increased industry costs

If research cannot be paid for via dealing commissions, portfolio managers (or rather the underlying funds) would need to make direct payments for these services. There will be administrative costs to both the sell-side and the buy-side to support the processing of payments (specifically invoices) from portfolio managers' operating expenses. Systems to facilitate these payments will need to be built and maintained.

A current payment mechanism for research is to collect through dealing commission and then distribute through CSAs, as set out in the answer to question 79. This method is used by the majority of major European portfolio managers. If CSAs were terminated and payment made directly by portfolio managers, this would involve re-negotiation of terms of business.

#### Impact assessment

If, notwithstanding the foregoing, ESMA seeks to proceed with its proposals, we believe it to be essential that it carry out an assessment to determine the impact and the extent to which the consumer, and market participants, will be affected.

<ESMA\_QUESTION\_82>

## **2.16. Investment advice on independent basis**

**Q83: Do you agree with the approach proposed in the technical advice above in order to ensure investment firm's compliance with the obligation to assess a sufficient range of financial instruments available on the market? If not, please explain your reasons and provide for alternative or additional criteria.**

<ESMA\_QUESTION\_83>

#### AFME Response

Overall, we believe that the MiFID 1 investment advice and suitability framework has worked well and should not be fundamentally changed. We agree that clients should receive clear and transparent information regarding the nature of the advice they are receiving.

With regard to paragraph 1.iii, we are not clear what is meant by "the number and variety of financial instruments considered comprises a substantial part of financial instruments and available on the market;" ESMA should make it clearer that this is a requirement i.e. "must or should comprise". We have also concerns over the wording "substantial part" as this seems to be somewhat contradictory to paragraph ii which requires that the number and variety of financial instruments should be "proportionate" to the scope of advice services rendered. In this context the word "substantial" does not appear appropriate and has a much broader meaning than "suffi-

cient” used in the Level 1 Directive. Therefore we would suggest that paragraph 1.iii be redrafted as “*the number and variety of financial instruments considered comprises a ~~substantial~~ sufficient part of financial instruments ~~and~~ available on the market;*”

We would also point out that the entire section is drafted from the point of view of advice to buy, but advice can also be to sell or hold, in which case many of the requirements outlined in the draft technical advice will be difficult to apply. We therefore suggest that this angle be explicitly considered when redrafting the advice. For example, at the moment, if a client of bank A has three instruments in his portfolio, all issued by bank A, and the likely advice is to sell one of those to acquire a new instrument, bank A would be precluded from presenting its advice as independent because, on the sale portion of the advice, it would be unable to consider a sufficiently diversified selection of instruments (point 1.i of the draft technical advice).

Finally, we would suggest that in order to ensure consumer protection and be consistent with the obligation to be fair, clear and not misleading, ESMA should consider in its technical advice restrictions on firms which do not meet the relevant MiFID 2 requirements but hold themselves out as “independent” and potentially use this for marketing purposes. If there are no restrictions on the marketing which firms can undertake in connection with their provision of independent advice, or the term “independent advice/adviser” is not protected, it could result in negative connotations being associated with non-independent advice. This could result in clients regarding non-independent advice as of lower quality or less valuable than independent advice, which is not the intention of MiFID 2. We are aware of such restrictions having been introduced in the context of the UK Retail Distribution review.

<ESMA\_QUESTION\_83>

**Q84: What type of organisational requirements should firms have in place (e.g. degree of separation, procedures, controls) when they provide both independent and non-independent advice?**

<ESMA\_QUESTION\_84>

#### AFME Response

We note that the new requirements will make it harder for banks to provide their clients with a traditional ‘relationship banking model’. The recent UK experience would seem to indicate that few firms will wish to provide both independent and non-independent advice at the same time but we agree that the examples ESMA has provided above could be used by firms to introduce appropriate organisational requirements for separation.

<ESMA\_QUESTION\_84>

**Q85: Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.**

<ESMA\_QUESTION\_85>

#### AFME Response

Yes, we would expect additional costs to arise from the proposals. This will also include countries such as the UK which has implemented the RDR but for retail clients only.

Additionally, paragraph 4(iii) of draft technical advice (p.130) requires that “a firm should not allow a relevant person to provide both independent and non-independent advice”. This could have significant cost implications as it would require two separate advice forces, resulting in duplication of staff, training etc.

<ESMA\_QUESTION\_85>

## 2.17. Suitability

**Q86: Do you agree that the existing suitability requirements included in Article 35 of the MiFID Implementing Directive should be expanded to cover points discussed in the draft technical advice of this chapter?**

<ESMA\_QUESTION\_86>

### AFME Response

Overall we believe that the MiFID 1 Suitability framework has stood the test of time and would query the very significant expansion of requirements which ESMA is proposing. Whilst we were broadly supportive of the MiFID 1 ESMA Guidelines on Suitability, we would query whether it is necessary to include this level of detail in the Implementing Directive.

We note that ESMA has not specifically confirmed that Article 35(2) of the MiFID 1 Implementing Directive (which allows certain knowledge to be assumed for professional clients when assessing suitability) will be maintained under MiFID 2. As we consider this an intrinsic element of the suitability regime, it is important that this is confirmed in due course.

Some detailed comments:

With regard to 1.ii the advice should be updated to reflect that the nature of the assessment of alternative financial instruments will be driven by the independent or non-independent nature of the adviser. This also applies to other sections e.g. 1.ix. Furthermore, the statement “every personal recommendation given to the client, or decision whether to trade, should be suitable, which includes, for example, whether or not to buy, hold or sell an investment” appears to go beyond the Level 1 definition of investment advice. The current definition of investment advice relates to recommendations to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument, as well as to whether one should or should not exercise any right conferred by a particular financial instrument to buy, sell, subscribe for, exchange, or redeem a financial instrument. The current drafting of 1.ii, by referring to advice “not to buy” potentially requires the adviser to justify why he is recommending that the client not buy each instrument within the investment realm being considered. We therefore suggest that 1.ii be redrafted in line with Level 1:

*“1.ii the suitability assessment is not limited to recommendations to buy a financial instrument. Every personal recommendation given to the client, or ~~decision whether to trade, in the case of portfolio management, every trading decision,~~ should be suitable, ~~which includes, for example, whether or not to buy, hold or sell an investment;~~”*

Whilst we agree that each product should be suitable for the client in question, the requirement in 1.iii “to assess whether an alternative instrument, less complex and with lower costs, would better meet the client’s profile” introduces a significant additional obligation and fundamental change to the suitability assessment. It is unclear what the expectations would be with regards to the other products the adviser would need to assess in order to arrive at an alternative recommendation and it is also unclear how compliance with this requirement could be assessed or monitored. Unless ESMA is able to provide much greater clarity on the practical steps required to meet this obligation, we suggest removing it from the advice.

With regard to 1.v, the definition of ‘switch’ is unclear and so are other terms such as ‘necessary information’ or ‘benefits’ in relation to switch. If ESMA is trying to quantify benefits this would

be difficult as it would mean assumptions about future performance. Similarly benefits such as aligning the portfolio with a client's investment objectives may not be easily quantifiable. Given this fundamental lack of clarity and given that switches are a series of sales and purchases, which, if advised, will be subject to suitability assessments in their own right, we would suggest removing section 1.v in its entirety as it is potentially duplicative and misleading.

Section 1.viii.c as drafted implies that tools are required for firms to meet their suitability obligations. In order to make it clear that advisers and firms can meet suitability obligations without employing tools we suggest that the first part of the section should be amended as follows: "1.viii.c ensuring ~~all~~any tools employed.... "

With regard to 1.ix, we would recommend that the reference to a married couple, as representing an example where a representative might not have been appointed, is removed by ESMA. Married couples may or may not appoint a representative. There should be no implicit presumption that they are unlikely to or any suggestion that they should be singled out for special consideration in this context.

AFME suggests that 1.xii is unclear and should be redrafted as follows "1.xii: where the applicable legal framework is not helpful for identifying who should be subject to the suitability assessment, firms should assess the financial situation and investment objectives of the underlying client and the knowledge and experience of the decision-maker, authorised to carry out transactions on behalf of the group or entity, for example, the representative of the legal entity or of the group of natural persons".

<ESMA\_QUESTION\_86>

**Q87: Are there any other areas where MiFID Implementing Directive requirements covering the suitability assessment should be updated, improved or revised based on your experiences under MiFID since it was originally implemented?**

<ESMA\_QUESTION\_87>

#### AFME Response

No. Overall the provisions of the MiFID 1 Implementing Directive appear to have worked well and we have no specific suggestions for changes. We note that ESMA has not specifically confirmed that Article 35.2 of the MiFID 1 Implementing Directive (assumption of knowledge and experience for professional clients) is maintained under MiFID 2. As we consider this an intrinsic element of the suitability regime, it is important that this is confirmed in due course.

The draft ESMA advice does not address the ability of a firm which would otherwise be responsible for suitability to rely on recommendations of a third party. Please also see our response to Q86

<ESMA\_QUESTION\_87>

**Q88: What is your view on the proposals for the content of suitability reports? Are there additional details or requirements you believe should be included, especially to ensure suitability reports are sufficiently 'personalised' to have added value for the client, drawing on any initiatives in national markets?**

<ESMA\_QUESTION\_88>

#### AFME Response

We agree that suitability reports should be restricted to retail clients and believe that no further elements of personalisation are necessary.

We would like ESMA to note that the proposal for providing a suitability report to retail clients *prior* to a transaction taking place may not always be in the client’s best interest, for example where timeliness is a key factor in completing a transaction which may also lead to issues with a firm’s obligation to provide best execution. We also believe that some retail clients may find the number of pre-sale reports and disclosures already mandated under MiFID 2 to be excessive (especially clients that trade or seek investment advice on a frequent basis) and we are aware that consumer research has shown that the majority of retail clients do not read the financial information they receive.

We also suggest that there should be flexibility in how (and what) suitability reports should cover, as agreed between the client and investment adviser. As noted above, providing suitability reports for every transaction recommended could be repetitive for clients and result in a negative client experience (as well as being difficult to implement operationally).<ESMA\_QUESTION\_88>

**Q89: Do you agree that periodic suitability reports would only need to cover any changes in the instruments and/or circumstances of the client rather than repeating information which is unchanged from the first suitability report?**

<ESMA\_QUESTION\_89>

AFME Response

Yes, we agree with this advice. The approach suggested would avoid the client being overwhelmed with unnecessary paperwork.

<ESMA\_QUESTION\_89>

## **2.18. Appropriateness**

**Q90: Do you agree the existing criteria included in Article 38 of the Implementing Directive should be expanded to incorporate the above points, and that an instrument not included explicitly in Article 25(4)(a) of MiFID II would need to meet to be considered non-complex?**

<ESMA\_QUESTION\_90>

AFME Response

MiFID Level 1 defined structured UCITS as complex which allowed non-structured UCITS to be sold on an execution only basis. However, we are concerned that ESMA has significantly extended the scope of the provisions to include other criteria which will lead to the inclusion of other products in the “complex category” and becoming subject to the appropriateness test. No clear rationale is provided for this extension beyond general investor protection concerns and the additional criteria such as references to “fundamentally alter the nature or risk of the investment” or having “the effect of making the instrument illiquid” are also unclear.

In addition, with regard to the additional criteria proposed, we would like to suggest that the boundary between complex and non-complex products for the purpose of the execution only service should be driven by their risk/reward profile, not an inappropriate focus on the detailed manner in which they are legally structured. Artificially excluding products simply because of the way in which they work rather than the return the investor will receive, risks unnecessarily excluding products that could be beneficial to investors.

<ESMA\_QUESTION\_90>



**Q91: Are there any other areas where the MiFID Implementing Directive requirements covering the appropriateness assessment and conditions for an instrument to be considered non-complex should be updated, improved or revised based on your experiences under MiFID I?**

<ESMA\_QUESTION\_91>

AFME Response

Yes - see our comments above. We would also suggest that the ESMA guidance on the appropriateness assessment of complex and non-complex instruments needs to be updated and re-issued for MiFID II as it was useful in the determination, particularly around products embedding a derivative.

AFME General Comment:

We note that ESMA has not specifically confirmed that Article 36 of the MiFID 1 Implementing Directive (which allows the necessary experience and knowledge to be assumed for professional clients) will be maintained under MiFID 2. As we consider this an intrinsic element of the appropriateness regime, it is important that this is confirmed in due course.

<ESMA\_QUESTION\_91>

## **2.19. Client agreement**

**Q92: Do you agree that investment firms should be required to enter into a written (or equivalent) agreement with their professional clients, at least for certain services? If yes, in which circumstances? If no, please state your reason.**

<ESMA\_QUESTION\_92>

AFME Response

No, we do not fully agree with ESMA's advice. Overall, we agree with ESMA that extending the requirement for client agreements to professional clients is largely aligned with existing market practice but are not convinced that this needs to be a formal MiFID requirement. Generally a firm will have written agreements in place with professional clients where there exists an ongoing relationship. However, we note that given the breadth of services and instruments offered to professional clients and eligible counterparties, it is not possible or practicable to have a **single** agreement with such clients in writing. Rather a firm may have several different agreements, often based on an industry standard, with these clients and ESMA should clarify that this is acceptable and meets the requirements. As discussed below, there are also some business areas that operate without written agreements, such as cash trading and some corporate finance transactions.

Professional clients are in a position to understand where risk (for example credit risk) exists, so firms and their professional clients in the best position to determine where an agreement has to be in writing. We, therefore, do not believe there is any need for a specific requirement to have all activities and transactions being subject to a written agreement. If ESMA insists on making this mandatory, we agree that additional agreements should only apply to 'new professional clients' and where the firm and the professional client intend to establish an ongoing relationship.

<ESMA\_QUESTION\_92>

**Q93: Do you agree that investment firms should be required to enter into a written (or equivalent) agreement for the provision of investment advice to any client, at least where the investment firm and the client have a continuing business relationship? If not, why not?**

<ESMA\_QUESTION\_93>

AFME Response

No - because in some situations clients prefer to have the option to receive investment advice without entering into an agreement about its provision. In some cases, the firm and the client may have an agreement in place for the provision of another service and investment advice may be requested and received in the context of the provision of the other service. In other cases, the firm may be prepared to take the risk of providing investment advice without a written contract in place because it takes the view that this will improve or cement the relationship with the client

If there were a requirement for a written agreement before any advice were provided, firms would probably protect themselves from inadvertent breaches by prohibiting the provision of investment advice other than in the context of a formal advisory relationship, thus disadvantaging the clients who benefit from the existing unwritten arrangements. See also our answer to Q.92.

<ESMA\_QUESTION\_93>

**Q94: Do you agree that investment firms should be required to enter into a written (or equivalent) agreement for the provision of custody services (safekeeping of financial instruments) to any client? If not, why not?**

<ESMA\_QUESTION\_94>

AFME Response

No - we believe that this is already standard practice and therefore do not see the reason for introducing an additional specific regulatory requirement.

<ESMA\_QUESTION\_94>

**Q95: Do you agree that investment firms should be required to describe in the client agreement any advice services, portfolio management services and custody services to be provided? If not, why not?**

<ESMA\_QUESTION\_95>

AFME Response

No, we do not agree. Given the changing nature of client relationships and business transactions such granularity would not be particularly helpful. Obviously if there is an existing agreement then this will cover the required services. However, especially for professional clients, we do not believe that specific regulatory requirements are required. However, the agreement could cross-refer to a service description otherwise available.

<ESMA\_QUESTION\_95>



**2.20.**

## **2.20. Reporting to clients**

**Q96: Do you agree that the content of reports for professional clients, both for portfolio management and execution of orders, should be aligned to the content applicable for retail clients?**

<ESMA\_QUESTION\_96>

### AFME Response General Comments

ESMA has failed to substantiate why it considers quarterly reporting to be more appropriate for portfolio management. The cost and benefits arising from the proposals in the technical advice have not been properly assessed. The proposals increase firms' costs which ultimately will be recovered from clients.

There is no recognition in the technical advice that many firms provide clients with online access to details of their holdings and our view is that where such access is in place there should be no obligation to provide quarterly reports.

Finally, many retail clients already object to the volume of paperwork they receive and do not wish to receive quarterly statements and may complain about being burdened with more paperwork. Retail clients should have the right not to receive quarterly reports.

### AFME Response

No, we do not agree. We believe that the information requirements for professional clients and eligible counterparties should not be aligned with those currently provided to retail clients. In general and based on the experience of our member firms, we believe that professional clients will require less detail than retail clients and whilst we believe they should be able to obtain necessary and essential information this should not be mandatory. Very often professional clients and ECPs do not want to be burdened with very detailed and overly frequent information and the MiFID 1 requirement of providing "essential information" in a durable medium struck the right balance of meeting their information needs without being too burdensome on either firms or their clients.

We would therefore suggest extending paragraph 2 to professional clients (and deleting paragraph 3) as follows:

*"Investment firms should be required to enter into an agreement with both eligible counterparties and professional clients with respect to nature, content, scope and timing of reporting".*

At the very least any requirement for the provision of information to professional clients should be on a "will be made available on request" basis rather than resulting from a mandatory proactive obligation.

<ESMA\_QUESTION\_96>



**Q97: Should investment firms providing portfolio management or operating a retail client account that includes leveraged financial instruments or other contingent liability transactions be required to agree on a threshold with retail clients that should at least be equal to 10% (and relevant multiples) of the initial investments (or the value of the investment at the beginning of each year)?**

<ESMA\_QUESTION\_97>

AFME response (with detailed input provided by WMA)

No, we do not agree with the advice as it is currently drafted. The information contained in the technical advice is unclear and does not enable AFME members to understand the nature of the proposal. For example, we are unclear whether the thresholds are determined by reference to the overall value of the portfolio as a whole or by reference to individual holdings. Similarly, there is no detail provided as to how movements of cash into and out of the portfolio should be treated such as transfers between portfolios, (for example, between spouses for the purposes of tax planning). In terms of individual holdings, significant falls in value may arise due to corporate actions such as demergers and spin offs. The cost of building systems to continuously monitor threshold breaches will be very high.

We do not believe it is appropriate to require portfolio managers to agree a threshold with retail clients (that should at least be equal to 10% (and relevant multiples) of the initial investments (or the value of the investment at the beginning of each year) which would trigger an obligation to produce a report. Portfolio managers have an obligation to ensure a client's portfolio is suitable and clients will under receive periodic reports. In addition, where there is a sudden market crash investment managers will engage with their clients to help them understand the potential impact in terms of their own circumstances having regard to their investment objectives, personal circumstances and their investment time horizon.

The 10% threshold appears somewhat arbitrary and there is a risk that in volatile markets clients could get overwhelmed by frequent statements without the appropriate context being provided or worse, inexperienced retail clients could be panicked into liquidating their portfolio.

<ESMA\_QUESTION\_97>

**Q98: Do you agree that Article 43 of the MiFID Implementing Directive should be updated to specify that the content of statements is to include the market or estimated value of the financial instruments included in the statement with a clear indication of the fact that the absence of a market price is likely to be indicative of a lack of liquidity?**

<ESMA\_QUESTION\_98>

AFME Response

No, we do not agree with ESMA's advice. We agree the basis of the valuations used in the report should be clear to the client. However, it is not always the case that an indicative price indicates a lack of liquidity, for example, a share may be suspended for a short time on a regulated market due to a corporate action. Furthermore as the provision would also apply to services other than portfolio management, we do not believe that the statement of financial instruments requires the inclusion of a marker or estimated value as there is no existing obligation on the firm to provide performance information. A manager may publish a Net Asset Value (NAV), but for funds grandfathered or exempted from AIFMD there is no uniform standard and therefore these NAVs might not be comparable or reliable. The type of mandate should dictate the information that should be provided to clients. Whilst we support the provision of periodic information under an ongoing mandate we would query this in the case of e.g. execution only services. ESMA's current advice



would require systems changes that would be disproportionate to the benefits of providing this information in the statement.

In wholesale markets, custodian banks provide several daily statements to clients (e.g. statement of holdings, transactions and pending transactions) which allow the clients to reconcile their position with the custodian. It is not the remit of the custodian to advise a value of a portfolio or whether an instrument is liquid. It is the responsibility of the client or the portfolio manager to value their own holdings and to determine whether an instrument is liquid or not. In any case it is not always the case that an indicative price indicates a lack of liquidity, for example, a share may be suspended for a short time on a regulated market due to a corporate action.

When daily or otherwise periodic valuation of assets is not undertaken or cannot be undertaken, the value of assets reported to clients by the custodian reflects the latest value reported in the securities accounting. In some rare cases, assets held on behalf of clients are not publicly listed or traded, and the accounting value provided by the client themselves is the only indication of their value. Whenever a daily or other periodic valuation of assets cannot be performed, clients should be informed in the client asset report of the date on which the last valuation was provided. We believe that this information would be far more reliable for the clients, and would not create unnecessary compliance uncertainties for the investment firms.

<ESMA\_QUESTION\_98>

**Q99: Do you consider that it would be beneficial to clients to not only provide details of those financial instruments that are subject to TTCA at the point in time of the statement, but also details of those financial instruments that have been subject to TTCA during the reporting period?**

<ESMA\_QUESTION\_99>

#### AFME Response

No, AFME does not support this proposal. The obligation for custodians to value financial instruments on behalf of their clients is a service not currently offered by many custodians. Additionally, many clients have valuation agreements with third party service providers. The UK FCA has recently conducted a cost benefit analysis exercise in relation to similar proposals which were dropped on the basis that they would make the provision of the service so unattractive as to potentially limit competition as a number of providers would be likely to exit this market.

Furthermore, it is not possible to provide detailed information to clients about assets subject to TTCAs. Such assets are transferred out of the client's account to the account of the collateral taker. Once these assets have been transferred, custodians cannot provide further information nor services in relation to these assets and hence, these assets should not be considered to be subject to MiFID protections. Clients should be clearly informed of the transfer and re-transfer at the moment of its occurrence as well as in the periodic reporting. Assets subject to security interests should be clearly earmarked and it is widespread market practice that the periodic reporting indicates which assets are earmarked.

In relation to services in which customer assets and funds are passed to a number of markets on a dynamic basis, where they would collateralise client obligations in accordance with the rules and applicable laws of the particular market, AFME considers again that the obligations may have the undesirable effect of reducing competition. For example, where clearing services are provided to clients, the rules of central counterparties will determine whether funds and financial instruments are lodged at the central counterparty under TTCA or as client assets subject to a security interest. Tracking the status of collateral through the clearing system in circumstances where a client is carrying out cleared business on a number of markets would be onerous and



very costly. Additionally, the snapshot information provided would be of limited benefit to clients.

<ESMA\_QUESTION\_99>

**Q100: What other changes to the MiFID Implementing Directive in relation to reporting to clients should ESMA consider advising the Commission on?**

<ESMA\_QUESTION\_100>

#### AFME Response

We believe that no further changes are necessary. With reference to our answers above we believe that the reporting requirements suggested by ESMA go too far especially with regard to professional clients.

<ESMA\_QUESTION\_100>

## **2.21. Best execution**

**Q101: Do you have any additional suggestions to provide clarity of the best execution obligations in MiFID II captured in this section or to further ESMA's objective of facilitating clear disclosures to clients?**

<ESMA\_QUESTION\_101>

#### AFME Response

We welcome ESMA's statement that MiFID 2 does not require major changes to the existing best execution regime, however, what ESMA describes as "a few additional requirements and clarifications", could potentially have a significant impact on firms. Furthermore, we believe that the requirements for the contents of the best execution policies are too detailed and would be best left to Level 3 Guidelines.

We also have a number of practical questions, for example with regard to the detail on execution policies in paragraph 1, firms will be required to check the fairness of the price proposed to clients. It is unclear whether and how this requirement would be applied in intra-group situations as bespoke OTC products are usually offered and priced by the same entity that sells the product. It is also unclear how this requirement should apply when different options for clearing and settlement are meant to form part of the best execution decision - firms may not have all the information regarding costs related to clearing and settlement, and may not be able to integrate those costs upfront when trading.

We welcome ESMA's recognition that there is a risk that presenting information on fees and charges may incentivise clients to choose the lowest figure, and do believe that this risk may be particularly acute in the case of retail clients whose execution summary now needs to "focus on the total known costs they face" (paragraph 8).

<ESMA\_QUESTION\_101>

**Q102: Do your policies and your review procedures already the details proposed in this chapter? If they do not, what would be the implementation and recurring cost of modifying them and distributing the revised policies to your existing clients? Where possible please provide examples of the costs involved.**



<ESMA\_QUESTION\_102>

#### AFME Response

Given the broad range of our members, there is a range of content contained in firms' best execution policies but it is unlikely that all policies will cover the precise detail set out by ESMA.

<ESMA\_QUESTION\_102>

## **2.22. Client order-handling**

**Q103: Are you aware of any issues that have emerged with regard to the application of Articles 47, 48 and 49 of the MiFID Implementing Directive? If yes, please specify.**

<ESMA\_QUESTION\_103>

#### AFME Response

No, we are not aware of any specific issues regarding the application of the client order handling requirements in the MiFID 1 Implementing Directive. We therefore agree with ESMA that these should be confirmed in MiFID 2.

<ESMA\_QUESTION\_103>

## **2.23. Transactions executed with eligible counterparties**

**Q104: Do you agree with the proposal not to allow undertakings classified as professional clients on request to be recognised as eligible counterparties?**

<ESMA\_QUESTION\_104>

#### AFME Response

No, we do not agree. Overall, we believe the client categorisation scheme has worked well and we do not believe that the changes proposed by ESMA are necessary. Member State discretion has ensured that the appropriate investor protection measures are maintained depending on the specific national circumstances.

Both MiFID 1 and 2 explicitly recognise that it is “the responsibility of the client, considered to be a professional client, to ask for a higher level of protection when it deems it is unable to properly assess or manage the risks involved”. Therefore we believe the new requirements, which have been introduced without proper rationale, are disproportionate, unjustified and limiting client choice. ESMA should preserve the concept of client choice enshrined in MiFID. The MiFID client classification system also has inbuilt protections and firms are required not to encourage clients to seek to opt-up. For example opt-up to eligible counterparty status should be permissible for a structure or vehicle by a large investor or private client (e.g. family office) that is undertaking professional trading provided it complies with the requirements and specifically requests such a status. The general investor protection obligations (treating fairly etc.) as well as the appropriateness test will still apply.

MiFID 2 excludes municipalities and local public authorities from the list of ‘per se’ professional clients although they still may be treated as professional clients upon request. This is likely to

have a particular effect in countries such as the UK, where these clients will now be required to go through the opt-up process should they wish to be treated as professional rather than retail clients. We also note the new third country regime where Member States may require the establishment of a branch for third country firms wishing to provide investment services to retail clients and opt-up professionals and this could have an impact on access to finance for local authorities. There are challenges in distinguishing between ‘regional governments’ (which can be treated automatically as professional clients) and ‘public sector bodies, local public authorities and municipalities’ (which will be retail clients unless they decide to opt up). It is also not clear whether local authority pension schemes would be considered a local authority or “other institutional investor”.

<ESMA\_QUESTION\_104>

**Q105: For investment firms responding to this consultation, how many clients have you already classified as eligible counterparties using the following approaches under Article 50 of the MiFID Implementing Directive:**

<ESMA\_QUESTION\_105>

AFME Response

AFME is a trade association therefore this answer is not applicable.

<ESMA\_QUESTION\_105>

**Q106: For investment firms responding to this consultation, what costs would you incur in order to meet these requirements?**

<ESMA\_QUESTION\_106>

AFME Response

AFME is a trade association therefore this answer is not applicable.

<ESMA\_QUESTION\_106>

## 2.24. Product intervention

### Q107: Do you agree with the criteria proposed?

<ESMA\_QUESTION\_107>

#### AFME Response

No, we do not agree with ESMA's advice as currently drafted. We agree with ESMA that given the range of factors outlined they do not all need to apply cumulatively but basing intervention powers on just one single factor present (see Article 7) would appear to be setting a very low overall threshold. Furthermore paragraph 8 seems to suggest that authorities may intervene even if no factors or criteria are met which calls into question the point of listing the detail of these factors.

<ESMA\_QUESTION\_107>

### Q108: Are there any additional criteria that you would suggest adding?

<ESMA\_QUESTION\_108>

#### AFME response

No we do not suggest adding additional criteria. The list of criteria already appears very extensive and therefore we do not believe that additional criteria should be required as both ESMA and national regulators are already given very extensive powers.

Overall, although the criteria are extensive, the direct impact on firms is still very unclear. First and foremost, firms will need transparency from regulators on the reasons for regulatory interventions, the scope and perimeter of such intervention and any potential cross-border impacts.

Any product intervention regime should fulfil the following criteria:

- the market should have sufficient certainty that legitimate commercial interests are protected;
- intervention powers are only exercised after a careful analysis both (i) in order to test the proposal and (ii) to ensure that the power is used proportionately (in this regard we note the protections in the Level 1 text);
- adequate account is taken of the impact of a ban or restriction on other product-types that are already in the market - we are particularly concerned about:
  - the potential unintended consequences of product intervention in causing spurious claims in relation to products which may have similar characteristics but do not represent a significant investor protection concern or threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system of the Union or any Member State;
  - the exercise of product intervention powers in relation to a product where sales have already been made to investors which will lead to uncertainty for product providers and distributors in relation to such sales.

Any uncertainty may have the unintended consequences of stifling constructive innovation of new categories of investment products suited to the changing economic climate and changing investor needs and choice for consumers and increased costs of products to protect against the risk of a product being subject to regulatory intervention.



We would also propose that there should be scope for a clear appeal procedure for firms related to product intervention given the potential significant impact of these powers.

<ESMA\_QUESTION\_108>

### 3. Transparency

#### 3.1. Liquid market for equity and equity-like instruments

**Q109: Do you agree with the liquidity thresholds ESMA proposes for equities? Would you calibrate the thresholds differently? Please provide reasons for your answers.**

<ESMA\_QUESTION\_109>

AFME Response

Yes

<ESMA\_QUESTION\_109>

**Q110: Do you agree that the free float for depositary receipts should be determined by the number of shares issued in the issuer's home market? Please provide reasons for your answer.**

<ESMA\_QUESTION\_110>

AFME Response

Yes, the number of depositary receipts is driven flexibly by the demand of investors and the relevant metric is the shares in issue of the underlying equity.

<ESMA\_QUESTION\_110>

**Q111: Do you agree with the proposal to set the liquidity threshold for depositary receipts at the same level as for shares? Please provide reasons for your answer.**

<ESMA\_QUESTION\_111>

AFME Response

Yes, the liquidity of depositary receipts stems from the liquidity of the underlying share

<ESMA\_QUESTION\_111>

**Q112: Do you agree with the liquidity thresholds ESMA proposes for depositary receipts? Would you calibrate the thresholds differently? Please provide reasons for your answers.**

<ESMA\_QUESTION\_112>

AFME Response

Yes

<ESMA\_QUESTION\_112>

**Q113: Do you agree that the criterion of free float could be addressed through the number of units issued for trading? If yes, what *de minimis* number of units would you suggest? Is there any other more appropriate measure in your view? Please provide reasons for your answer.**

<ESMA\_QUESTION\_113>





AFME Response

Yes

<ESMA\_QUESTION\_113>

**Q114: Based on your experience, do you agree with the preliminary results related to the trading patterns of ETFs? Please provide reasons for your answer.**

<ESMA\_QUESTION\_114>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_114>

**Q115: Do you agree with the liquidity thresholds ESMA proposes for ETFs? Would you calibrate the thresholds differently? Please provide reasons for your answers, including describing your own role in the market (e.g. market-maker, issuer etc).**

<ESMA\_QUESTION\_115>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_115>

**Q116: Can you identify any additional instruments that could be caught by the definition of certificates under Article 2(1)(27) of MiFIR?**

<ESMA\_QUESTION\_116>

AFME Response

Exchange Traded Certificates should be included given the similarity in their liquidity characteristics

<ESMA\_QUESTION\_116>

**Q117: Based on your experience, do you agree with the preliminary results related to the trading patterns of certificates? Please provide reasons for your answer.**

<ESMA\_QUESTION\_117>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_117>

**Q118: Do you agree with the liquidity thresholds ESMA proposes for certificates? Would you calibrate the thresholds differently? Please provide reasons for your answer.**

<ESMA\_QUESTION\_118>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_118>

**Q119: Do you agree that the criterion of free float could be addressed through the issuance size? If yes, what *de minimis* issuance size would you suggest? Is there any other more appropriate measure in your view? Please provide reasons for your answer.**

<ESMA\_QUESTION\_119>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_119>

**Q120: Do you think the discretion permitted to Member States under Article 22(2) of the Commission Regulation to specify additional instruments up to a limit as being liquid should be retained under MiFID II?**



<ESMA\_QUESTION\_120>

#### AFME Response

No, AFME believes that this should remain an objective and quantitative measure and consistency of its application remains paramount across member states.

<ESMA\_QUESTION\_120>

### **3.2. Delineation between bonds, structured finance products and money market instruments**

**Q121: Do you agree with ESMA's assessment concerning financial instruments outside the scope of the MiFIR non-equity transparency obligations?**

<ESMA\_QUESTION\_121>

#### AFME Response

**No. AFME does not agree with ESMA's proposed definition and instead recommend that the definition of money market instruments is as set out below.**

***(i) We recommend that MiFID Delegated Acts adopt a definition that is consistent with the Money Market Regulation***

We believe that inconsistent regulation of the money markets is unhelpful and will create a distorted and fragmented market. We do not believe that there is any reason for MiFID to have a different definition from the final definition that will be contained in the Money Market Regulation.

Unlike the definition proposed by ESMA, the Eligible Assets Directive and the European Commission's Money Market Fund Regulation proposal also consider the following instruments as money market instruments: (i) financial instruments that have a residual maturity of up to and including 397 days; (ii) financial instruments that undergo regular yield adjustments in line with money market conditions at least every 397 days; and (iii) financial instruments with risk profiles, including credit and interest rate risks, corresponding to that of financial instruments that have maturity as reference in (i) or 397 days or less from issuance or are subject to yield adjustments as in (ii).

Further, there have been discussions in the co-legislative process of the Money Market Regulation of extending the period of residual maturity of a typical money market instrument from 397 days to 2 years.

Therefore, we recommend the definition to include instruments with short residual maturities. Further, if the final Money Market Fund Directive extends European Commission proposal for a period from 397 days to 2 years, MiFID II should also adopt this approach.

***(ii) ABCPs should be treated as money market instruments***

AFME strongly disagrees that ABCPs should be categorised as structured finance products rather than money market instruments. AFME recommends that they should be treated as money market instruments. The reasoning that ESMA has provided is that ABCPs are both structured finance products and money market instruments and as such should be treated as structured finance products. If the same logic is applied to commercial paper, which ESMA has deemed a

money market instrument, commercial paper should be considered like any other bond because the only difference is that it has a very short term. Therefore, the reasoning is inappropriate.

The only difference between a CP and an ABCP is that the cash flows of an ABCP are derived from an underlying pool of assets.

**(iii) *No instruments have equivalent features – “other instruments with equivalent features” should be changed to “other instruments with substantially equivalent features”***

We note that the ESMA definition of Money Market Instruments “*are limited to those instruments expressly stated to be treasury bills, certificates of deposit, commercial paper and other instruments with equivalent features*”. No single instrument has identical features to another in fixed income; therefore, based on ESMA’s drafting, instruments that are money market instruments that are equivalent for all intents and purposes would not be captured. We propose the language to be changed to “*...and other instruments with substantially equivalent features*”.

**(iv) *No instrument is expressed to be a particular type of instrument***

It should also be noted that instruments are never “*expressed*” to be a particular type of instrument; therefore, we don’t support the use of this language

**(v) *Importance of getting this right***

We stress that the setting the right definition for money market instruments is of vital importance.

The European Commission has recognised (in its September 2013 proposal) that MMFs are an “*important source of short-term financing for financial institutions, corporate bodies and governments. For example, almost 40% of short-term debt issued by the banking sector is held by MMFs. MMFs represent a crucial link bringing together demand and offer for short-term money. With total assets under management of roughly EUR 1 trillion, MMFs represent around 15% of the European fund industry*”.

<ESMA\_QUESTION\_121>

### **3.3. The definition of systematic internaliser**

**Q122: For the systematic and frequent criterion, ESMA proposes setting the percentage for the calculation between 0.25% and 0.5%. Within this range, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications.**

<ESMA\_QUESTION\_122>

#### AFME Response

Taking into account the range of views across AFME members 0.4% is the appropriate level within the range where AFME feels the systematic and frequent calculation should be set.

However, as per the response to question 122 of the CP in relation to the Trading Obligation, AFME does not agree that the parameters used to define what is systematic and frequent in the context of the SI regime should be inverted to define what is considered as non-systematic, ad-hoc, irregular and infrequent in the context of that OTC trading. Many AFME members may



qualify as an SI for the majority of names that they trade and as such, will be publishing quotes and where appropriate executing trades within this structure. This does not however mean that on an ad-hoc, non systematic, irregular and infrequent basis these firms will not need to trade on an OTC basis to best meet the complex needs of their clients. To best meet the complex needs of their clients, AFME SI firms may also need to trade on an OTC basis, which is not ad-hoc, non-systematic, irregular and infrequent basis.

<ESMA\_QUESTION\_122>

**Q123: Do you support calibrating the threshold for the systematic and frequent criterion on the liquidity of the financial instrument as measured by the number of daily transactions?**

<ESMA\_QUESTION\_123>

AFME Response

Yes, frequent as a term is clear, and it is logical that frequency would be measured in this way

<ESMA\_QUESTION\_123>

**Q124: For the substantial criterion, ESMA proposes setting the percentage for the calculation between 15% and 25% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients and between 0.25% and 0.5% of the total turnover in that financial instrument in the Union. Within these ranges, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the thresholds should be set at levels outside these ranges, please specify at what levels these should be with justifications.**

<ESMA\_QUESTION\_124>

AFME Response

Taking into account the range of views across AFME members, AFME feels 20% is the appropriate level within the range of total turnover of the investment firm, and 0.4% is the appropriate level within the range of total turnover in Union where the calculations should be set.

<ESMA\_QUESTION\_124>

**Q125: Do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of shares traded? Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.**

<ESMA\_QUESTION\_125>

AFME Response

Yes

<ESMA\_QUESTION\_125>

**Q126: ESMA has calibrated the initial thresholds proposed based on systematic internaliser activity in shares. Do you consider those thresholds adequate for:**

<ESMA\_QUESTION\_126>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_126>

**Q127: Do you consider a quarterly assessment of systematic internaliser activity as adequate? If not, which assessment period would you propose? Do you consider that one month provides sufficient time for investment firms to establish all the necessary arrangements in order to comply with the systematic internaliser regime?**

<ESMA\_QUESTION\_127>

#### AFME Response

AFME feels that quarterly assessment would be too frequent as this would become distorted by seasonal changes and that annual assessment would present a more fair and accurate assessment. On that basis AFME also believes the calculations referred to in questions 122 and 124 above should also be set annually.

Where an investment firm satisfies the definition of a systematic internaliser in its first instrument then one month is considered to be far too short to put place all necessary arrangements. However, AFME feels that where a firm is already an SI in other instruments then one month should be sufficient.

<ESMA\_QUESTION\_127>

**Q128: For the systematic and frequent criterion, do you agree that the thresholds should be set per asset class? Please provide reasons for your answer. If you consider the thresholds should be set at a more granular level (sub-categories) please provide further detail and justification.**

<ESMA\_QUESTION\_128>

#### AFME Response

##### **FIXED INCOME**

**No. AFME does not agree.**

AFME recommends that there should be different SI thresholds for bonds/SFPs and derivatives. We do not believe that a differentiation between the SI bond and SFP thresholds is necessary. However, we do propose that a differentiation between issue size categories will be optimal. Specifically, the issue size categories for SI calibration should be: (i) EUR  $\geq$  5bn, (ii) EUR 500mm to EUR 5bn; and (iii) EUR  $\leq$  500mm. Generally we would expect ESMA to set the thresholds for SI qualification slightly lowers for the larger bond sizes (where there are likely to be more market makers with generally smaller market shares), and slightly higher for smaller bond sizes (where there are likely to be fewer, more concentrated market makers). This is consistent with AFME's proposals for setting the thresholds that we put forward in response to **CP Question 134**. We think that three separate bond size categories will be sufficient for this purpose.

Such an approach is also consistent for cash and SFP with regard to the categorisation of instruments for the purposes of liquidity calculations (please see AFME's response to **DP Questions 112 and 113**). Applying the same approach for SI calibration and liquidity calibration ensures simplicity and consistency.

##### **FOREIGN EXCHANGE**

For FX, the GFXD partially agrees with ESMA's opinion that any thresholds should be established on an asset class by asset class basis (i.e. FX v Equity) as each asset class has its own characteristics with respect to market conditions, liquidity profiles and trading patterns.

Additionally for FX, the GFXD believes that thresholds should be set at a more granular level as per our responses to the transparency questions in the Discussion Paper. The FX table included within Annex 3.6.1 (Financial instruments taxonomy and metrics for the calculation of the liquidity criteria (average size of transaction) on page 134 of the Discussion Paper references the same taxonomy that is included within the ISDA product taxonomy ([http://www2.isda.org/attachment/NTQzOQ--/ISDA\\_OTC\\_Derivatives\\_Taxonomies\\_o\\_version2012-10-22.xls](http://www2.isda.org/attachment/NTQzOQ--/ISDA_OTC_Derivatives_Taxonomies_o_version2012-10-22.xls)) and should be used by market participants to harmonize classification across the FX asset class.

The GFXD believes that an investment firm trading FX should be specifically categorized as a Systematic Internaliser (S)I depending on its activity at the FX sub-product, currency pair level and maturity (e.g. a 3 month EUR/USD Vanilla Option). Each SI will be active in different financial instruments and should not be classified as a SI in a financial instrument in which they are traditionally not an active market participant.

<ESMA\_QUESTION\_128>

**Q129: With regard to the ‘substantial basis’ criterion, do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of instruments traded. Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.**

<ESMA\_QUESTION\_129>

AFME Response

#### **FIXED INCOME**

**No. AFME does not agree that the thresholds should be based on the turnover as opposed to the volume. AFME does agree with the definition of total trading by investment firm.**

**(i) *We believe that volume turnover should be based on notional volume rather than on market value. We believe that this extends to all volume calculations.***

Reasons:

- Basing turnover thresholds on market value will introduce unnecessary price volatility as a factor into the threshold calculations and thereby introduce uncertainty. For example, if the price suddenly fell from one trade to the next, the aggregate turnover would be highly distortive. It also introduces arbitrage opportunities for firms to price in the SI threshold.
- Instruments do not trade on a price\*volume manner – the size of trades, there thereby volume, is determined on the basis of notional not price.
- Market valuation methodologies are not standardised and are highly proprietary. Using market values would create inconsistencies. These inconsistencies would be more notable in the more illiquid end of the spectrum.

**(ii) *Non-price forming trades should not be included in the investment firm SI calculations***

Many trades that investment firms undertake in instruments are not price forming trades but are trades undertaken for other reasons. For example, technical trades such as those that occur for the purposes of risk management (e.g. interaffiliate trades) are not price forming trades. Investment firms should not be mandated to consider non-performing trades in the SI assessment

calculations. If these were to be included, the numerators of the calculations of frequent or substantial would be severely distorted and would discourage such non-price forming trades, to the detriment of risk management and collateral flow.

We also recommend that primary trades are not price forming trades because at this stage everyone is a price taker. The calculations would be distorted and trading activity would be exaggerated (the bond could in practice be totally illiquid and not traded post trade date if locked up by the buy-side).

Other examples also include securities financing transactions.

Further, extremely small non-price forming trades should also be scrubbed from the data set of trade count. These are again typically technical trades, such that they are not price forming. For example, a very small trade may be an amendment to a previous trade (which had the wrong amount booked incorrectly). These small sizes are typically in the region of EUR 10,000 in size or less<sup>23</sup>. Including such trades in the calculations would be highly distortive.

**(iii) We agree with the calculation of the total trading by the investment firm for the purposes of the internalised thresholds (criteria 1 threshold). Specifically, total OTC trading compared to total trading, including OTC and venue trades in a particular instrument.**

## FOREIGN EXCHANGE

For FX, the GFXD supports a notional based assessment (i.e. total notional as a percentage of the firms total trading activity). An example of this, using the more granular level described in our response to question 128 of the Consultation Paper, would be:

- An investment firms trading volume in 3 month EUR/USD Vanilla Option, versus
- Europe Union wide trading volume in 3 month EUR/USD Vanilla Option

The GFXD also believes that with respect to the definition of total trading, it would be more appropriate to use the total notional rather than turnover. We believe this would give a more accurate representation of the trading activity of an investment firm rather than turnover (turnover interpreted to mean notional\*price).

<ESMA\_QUESTION\_129>

**Q130: Do you agree with ESMA's proposal to apply the systematic internaliser thresholds for bonds and structured finance products at an ISIN code level? If not please provide alternatives and reasons for your answer.**

<ESMA\_QUESTION\_130>

### AFME Response

**Yes. AFME agrees.**

We strongly recommend for this to be aligned with the approach taken in the calculation of the liquidity thresholds. Specifically, we support an ISIN level approach for the determination of whether a firm is a systematic internaliser and for the calculation of the liquidity thresholds for bonds and SFPs (please refer to AFME's response to **DP Question 113**).

<ESMA\_QUESTION\_130>

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<sup>23</sup> We note that not all trades below EUR 10,000 are non-price forming

**Q131: For derivatives, do you agree that some aggregation should be established in order to properly apply the systematic internaliser definition? If yes, do you consider that the tables presented in Annex 3.6.1 of the DP could be used as a basis for applying the systematic internaliser thresholds to derivatives products? Please provide reasons, and when necessary alternatives, to your answer.**

<ESMA\_QUESTION\_131>

AFME Response

### **FOREIGN EXCHANGE**

For FX, the GFXD agrees that there should be aggregation to allow the application of the systematic internaliser definition. For FX, we recommend that aggregation is performed to the same level as referenced in the FX table included within Annex 3.6.1 (Financial instruments taxonomy and metrics for the calculation of the liquidity criteria (average size of transaction) on page 134 of the Discussion Paper references the same taxonomy that is included within the ISDA product taxonomy ([http://www2.isda.org/attachment/NTQzOQ--/ISDA\\_OTC\\_Derivatives\\_Taxonomies\\_o\\_version2012-10-22.xls](http://www2.isda.org/attachment/NTQzOQ--/ISDA_OTC_Derivatives_Taxonomies_o_version2012-10-22.xls)). The GFXD believes that the FX asset class should be categorized to the sub-product, currency pair level and maturity (e.g. a 3 month EUR/USD Vanilla Option).

<ESMA\_QUESTION\_131>

**Q132: Do you agree with ESMA's proposal to set a threshold for liquid derivatives? Do you consider any scenarios could arise where systematic internalisers would be required to meet pre-trade transparency requirements for liquid derivatives where the trading obligation does not apply?**

<ESMA\_QUESTION\_132>

AFME Response

### **FOREIGN EXCHANGE**

For FX, the GFXD agrees with ESMA's proposal that a threshold is required for liquid derivatives and agrees that there will be scenarios where systematic internalisers would be required to meet pre-trade transparency requirements for liquid derivatives where the trading obligation does not apply.

<ESMA\_QUESTION\_132>

**Q133: Do you consider a quarterly assessment by investment firms in respect of their systematic internaliser activity is adequate? If not, what assessment period would you propose?**

<ESMA\_QUESTION\_133>

AFME Response



## **FIXED INCOME**

**Yes partially. AFME partially agrees.**

- (i) ***Quarterly assessment is appropriate with a one month assessment so long as investment firms have up to 1 month after the quarter to calculate whether they qualify as an SI***

**AFME believes a quarterly assessment is appropriate for cash bonds and SFPs with up to a one month period for calculation. Firms should be able to adopt the SI status any time within the month given for calculation (i.e. they should not need to wait until the last day of the month).**

We note that in order to undertake their SI frequent and substantial calculations, investment firms need EU wide data on the total number of transactions and total volume turnover in the same financial instrument in the EU. In order to be able to undertake their calculations within the one month period given, ESMA needs to provide the EU wide information in a timely manner. Specifically, we propose that ESMA provides the EU wide data one week following the end of the quarter, such that investment firms have the following three weeks to undertake their calculations and make system changes. As proposed in our answers to **DP Questions 132 and 178**, data collection processes should be simple and automated, meaning that our proposed timings should be achievable.

- (ii) ***The quarterly assessments should be predefined***

**The quarterly assessment should be based on predefined quarterly periods for all bonds and SFPs (i.e. reference dates). For example, the quarterly assessment period for the first quarter of the year should be 1 January to 31 March – firms should undertake their calculations in April based on their frequency of trades and volume of trades during the first quarter and the result of the SI assessment should come into effect on the 1 May.**

- (iii) ***For new issues, the bond/SFP needs to have been issued within the first month of the quarter period to be considered in the SI assessment for that quarter***

It is necessary to ensure a bond/SFP is only captured in the quarter end calculations once it has traded over a period of time that is sufficiently representative of its trading pattern and frequency.

Further, by ensuring a bond is assessed in the calculations once there is sufficient trade data avoids adverse impacts on the issuance of new bonds. Otherwise, there will be perverse incentives for issuers to arbitrage the SI calibrations – issuers would be incentivised to issue their bonds at the end of the quarterly assessment period. We suggest that a bond/SFP only be considered in the SI calculations of a particular quarter if it has been issued in the first month of the quarter assessment period.

## **FOREIGN EXCHANGE**

For FX, the GFXD believes that data should be provided by ESMA to help an investment firm validate its activity in a specific financial instrument. The GFXD suggests that ESMA should publish the total notional traded in a particular financial instrument, which would easily allow an investment firm to assess their level of activity.

The GFXD believes that a quarterly assessment of activity is too short to allow ESMA sufficient time to gather and analyze data and to subsequently report the total notional data on their website. Additionally, the GFXD believes it is unrealistic to expect a SI to update their technology

systems to accommodate such frequent calibrations. The GFXD suggests that a very minimum ESMA produces updated data every 6 months (and potentially should be in line with other data collation exercises and be every 2 years) and we support the text referenced in on page 197, #23 the Consultation Paper:

*An important aspect of the application of the frequent and systematic criterion and the substantial criterion is the relevant period for calculating the thresholds. As for the equity systematic internaliser regime, ESMA is of the view that the relevant thresholds should be calculated over a period long*

*enough to minimise the risk of capturing episodic internalisation and to give legal certainty to investment firms. For that reason ESMA proposes that investment firms should take into account the activity within each calendar quarter when calculating the relevant thresholds.*

Finally, the GFXD believes that it is also necessary to implement mechanisms that allow investment firms to submit requests to ESMA (or to their local National Competent Authority) asking for the re-assessment of their classification as a SI in a particular financial instrument. It is likely that the trading profiles of a specific financial instrument will change during the assessment process (for instance due to a change in liquidity), which would result in an investment firm being incorrectly classified. The GFXD believes measures should also exist to ensure that any re-classification process is controlled and objective rather than self-defining, and should be applied on a rules based approach for all investment firms.

<ESMA\_QUESTION\_133>

**Q134: Within the ranges proposed by ESMA, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications and where possible data to support them.**

<ESMA\_QUESTION\_134>

AFME Response

## **FIXED INCOME**

***(i) The Minimum Trading Frequency of once per week should apply to instruments in which there is a Liquid markets***

We encourage ESMA to ensure greater consistency between the thresholds to qualify as an SI in liquid and illiquid instruments than is implied by the table on page 198 of the CP. If we take the examples provided on page 127 of the DP, an instrument could be deemed liquid if it trades just 240 times per year. The range of percentages for liquid instruments presented on page 198 of the CP (2 to 5% across bonds and SFPs) imply that firms could qualify as an SI in a liquid instrument that it trades fewer than 5 times per year. This appears inconsistent with the minimum frequency required for illiquid instruments of once per week. Therefore, we recommend that ESMA adopt a Minimum Trading Frequency of once per week for liquid instruments, in addition to illiquid instruments.

***(ii) The “Systematic and Frequent thresholds (liquid instruments)”, and “Substantial Basis (criteria 2)” should be calibrated with the objective of capturing approximately 85-95% of market share of price-forming trades in each instrument***

It is essential that the SI thresholds under the MiFID II regime are not anti-competitive or introduce an unlevel playing field. Specifically, firms with similar market shares in an instrument

should be treated in the same way and market makers that are prevalent in a particular market should be deemed an SI – it is essential that a two-tier system is not introduced.

We stress that ESMA needs to achieve an important balance with regards to setting the threshold. Setting the thresholds too low could result in a barrier to entry for smaller or newer market participants by requiring them to implement the technologies required to comply with the SI obligations and could be a deterrent to liquidity provision or market making. Setting the thresholds too high could result in an uneven playing field between market makers, with only the larger market makers required to comply with the SI obligations and smaller market makers not subject to those same obligations and therefore offering investors the opportunity to trade under the OTC regime (where transaction costs could be lower given the absence of pre-trade transparency obligations and other requirements).

We propose that ESMA set the SI thresholds for “frequent and systematic (liquid instruments)” and “substantial (criteria 2)” such that 85 – 95% of the market share of price-forming trades in a given instrument is captured in the SI regime. We believe this will ensure that the vast majority of liquidity provided by market making firms and other liquidity providers in any given instrument is brought into scope, and will help ensure a level playing field among investment firms in the relevant markets.

For “substantial” category 1, we agree with the proposed percentages of 25% for bonds and 30% for SFPs.

***(iii) There should be different thresholds for bonds and SFPs based on the issue size category***

For bonds and SFPs, as discussed in response to **DP Question 112**, the nature of bond trading differs depending on the issue size of the instrument. Therefore we believe that the determination of thresholds for the purposes of “frequent and systematic” and “substantial” should be done at the level of each of the three issue size categories that we have also suggested to determine whether there is a liquid market in an instrument: greater than or equal to EUR 5bn, EUR 500mm – 5bn and less than or equal to EUR 500mm. The calculations for both tests should be done at the level of the individual ISINs.

Therefore, if ESMA agrees with our proposal, the percentage thresholds that should be set for each issue size category – both for the “frequent and systematic (liquid instruments)” and “substantial (criteria 2)” tests – will need to differ depending on the number of investment firms that are actively engaged in providing liquidity to each issue size category. ESMA will require a greater understanding of the composition of market shares in each issue size category, both in terms of the number of market makers, and their relative market shares. As ESMA notes in DP 3.13 paragraphs 1 and 2, in order to make this assessment, ESMA will need to obtain robust, high quality data for the issue size categories and instruments from trading venues and APAs so that the percentages are calibrated based on actual and representative market data. We welcome ESMA’s efforts in this regard as we consider this to be the most important factor in setting the thresholds appropriately.

***(iv) Non-price forming trades should not be included in the investment firm SI calculations***

Many trades that investment firms undertake are not price forming trades but are trades undertaken for other reasons. For example, technical trades such as those that occur for the purposes of risk management (e.g. interaffiliate trades) are not price forming trades. Investment firms should not be mandated to consider non-price-forming trades in the SI assessment calculations. If these were to be included, the numerators and denominators of the calculations of frequent or

substantial would be severely distorted and would discourage such non-price forming trades, to the detriment of risk management and collateral flow.

We also recommend that primary trades are not price forming trades because at this stage everyone is a price taker. The calculations would be distorted and exaggerate trading activity (the bond could in practice be totally illiquid and not traded post trade date if locked up by the buy-side).

Other examples also include securities financing transactions and trade amendments.

Further, extremely small non-price forming trades should also be scrubbed from the data set of trade count. These are again typically technical trades, such that they are not price forming. For example, a very small trade may be an amendment to a previous trade (which had the wrong amount booked incorrectly). These small sizes are typically in the region of EUR 10,000 in size or less<sup>24</sup>. Including such trades in the calculations would be highly distortive.

**(v) *Block level not allocation level trades should be used in the frequent and systematic calculations***

Even though matching is a very important process, it is essential that the allocations are not included in the trade frequency count. Rather, it should be the block level trades that are counted. For example, if a bank undertakes a trade of EUR 50mm notional with a client and that client allocates the EUR 50mm to 100 different funds, the trade count should be one (one trade of EUR 50mm and not 100 trades of EUR 500,000). Counting the allocation level would be misleading and would incorrectly inflate the number of trades. It is essential that this is clarified by ESMA.

## **FOREIGN EXCHANGE**

The GFXD recommends that before any thresholds are set, a liquidity study should be performed using data collated over a period of time long enough to ensure that a wide range of market events are captured. We also believe it is inappropriate to apply a consistent threshold across all asset classes, especially when comparing markets that trade less frequently than FX, estimated to be \$5.3 trillion/day as reported by the Bank of International Settlements in their Triennial Central Bank Survey: Foreign Exchange Turnover in April 2013 (<http://www.bis.org/publ/rpfx13fx.pdf>). In the absence of data regarding the total size of trading in the European Union, members cannot suggest appropriate thresholds, hence the observation to perform a liquidity study.

The GFXD would like to suggest that ESMA considers the impact of any final decisions on the future commercial landscape of the markets for example, regardless of how high or low the SI thresholds are set, they should be set such that there are no cliff edges which allow market makers with a similar market shares to be treated differently.

As an observation, the ESMA analysis for liquidity thresholds for bonds would reveal inconsistencies with the suggested SI thresholds. According to the DP, an instrument could be deemed liquid if it trades just 240 times per year. According to the CP, an investment firm could be an SI trading just 2-3% of transactions. Therefore, for an instrument that only just qualifies as liquid, an investment firm could qualify as an SI trading that instrument just 4.8 times per year, or less than once every two months on average, which seems far too low.

<ESMA\_QUESTION\_134>

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<sup>24</sup> This does not mean all trades below EUR 10,000 are non-price-forming

**Q135: Do you consider that thresholds should be set as absolute numbers rather than percentages for some specific categories? Please provide reasons for your answer.**

<ESMA\_QUESTION\_135>

AFME Response

### **FIXED INCOME**

**No. AFME does not agree.** As discussed in answer to **CP Question 134**, we believe that there should be a minimum trading frequency for both liquid and illiquid instruments. However, the percentage thresholds are essential to ensuring 85-95% of the market share of price forming trade for bonds and SFPs are captured by the SI regime.

### **FOREIGN EXCHANGE**

The GFXD recommends that before any thresholds are set, a liquidity study should be performed using data collated over a period of time long enough to ensure that a wide range of market events are captured. We also believe it is inappropriate to apply a consistent threshold across all asset classes, especially when comparing markets that trade less frequently than FX, estimated to be \$5.3 trillion/day as reported by the Bank of International Settlements in their Triennial Central Bank Survey: Foreign Exchange Turnover in April 2013 (<http://www.bis.org/publ/rpfx13fx.pdf>). In the absence of data regarding the total size of trading in the European Union, members cannot suggest appropriate thresholds, hence the observation to perform a liquidity study.

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<ESMA\_QUESTION\_135>

**Q136: What thresholds would you consider as adequate for the emission allowance market?**

<ESMA\_QUESTION\_136>

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<ESMA\_QUESTION\_136>

## **3.4. Transactions in several securities and orders subject to conditions other than the current market price**

**Q137: Do you agree with the definition of portfolio trade and of orders subject to conditions other than the current market price? Please give reasons for your answer?**

<ESMA\_QUESTION\_137>



#### AFME Response

Yes, but ESMA could identify criteria that allows for the evolution of order types that may fall into this in future

<ESMA\_QUESTION\_137>

### **3.5. Exceptional market circumstances and conditions for updating quotes**

**Q138: Do you agree with the list of exceptional circumstances? Please give reasons for your answer. Do you agree with ESMA's view on the conditions for updating the quotes? Please give reasons for your answer.**

<ESMA\_QUESTION\_138>

#### AFME Response

Exceptional circumstances should include an instrument going into auction on a relevant market and an instrument added to a restricted list. AFME strongly disagrees that an SI which withdraws its quotes is required to inform the NCA or its client that it has done so. This information is in any case already publically available through an APA. Cancellation of the quote therefore serves as the notification itself. Referring to Draft Technical Advice para 1 (v), active flagging of withdrawal of quotes owing to a risk limit breach could in fact exacerbate the risk and may result in lower limits being set.

<ESMA\_QUESTION\_138>

### **3.6. Orders considerably exceeding the norm**

**Q139: Do you agree that each systematic internaliser should determine when the number and/or volume of orders sought by clients considerably exceed the norm? Please give reasons for your answer?**

<ESMA\_QUESTION\_139>

#### AFME Response

Yes, the Systematic Internaliser is best placed to understand its own risk profiles.

<ESMA\_QUESTION\_139>

### **3.7. Prices falling within a public range close to market conditions**

**Q140: Do you agree that any price within the bid and offer spread quoted by the systematic internaliser would fall within a public range close to market conditions? Please give reasons for your answer.**

<ESMA\_QUESTION\_140>



#### AFME Response

#### **FIXED INCOME**

Yes, the drafting is clear in its meaning that any price within the bid and offer spread quoted by the systematic internaliser would fall within a public range close to market conditions.

#### **FOREIGN EXCHANGE**

For FX, the GFXD believes that any price within the bid/offer spread should fall within a range close to market conditions. The FX markets already benefit from high levels of transparency with data being available to the public via numerous sources, such as Google Finance, Yahoo Finance, Bloomberg and Reuters.

<ESMA\_QUESTION\_140>

### **3.8. Pre-trade transparency for systematic internalisers in non-equity instruments**

**Q141: Do you agree that the risks a systematic internaliser faces is similar to that of an liquidity provider? If not, how do they differ?**

<ESMA\_QUESTION\_141>

#### AFME Response

#### **FIXED INCOME**

Yes. AFME agrees.

#### **FOREIGN EXCHANGE**

For FX, the GFXD agrees that the risks faced by a SI are similar to that of a liquidity provider.

<ESMA\_QUESTION\_141>

**Q142: Do you agree that the sizes established for liquidity providers and systematic internalisers should be identical? If not, how should they differ?**

<ESMA\_QUESTION\_142>

#### AFME Response

#### **FIXED INCOME**

Yes. AFME agrees.

<ESMA\_QUESTION\_142>

## 4. Data publication

### 4.1. Access to systematic internalisers' quotes

**Q143: Do you agree with the proposed definition of “regular and continuous” publication of quotes? If not, what would definition you suggest?**

<ESMA\_QUESTION\_143>

AFME Response

Yes

<ESMA\_QUESTION\_143>

**Q144: Do you agree with the proposed definition of “normal trading hours”? Should the publication time be extended?**

<ESMA\_QUESTION\_144>

AFME Response

Yes

<ESMA\_QUESTION\_144>

**Q145: Do you agree with the proposal regarding the means of publication of quotes?**

<ESMA\_QUESTION\_145>

AFME Response

Yes

<ESMA\_QUESTION\_145>

**Q146: Do you agree that a systematic internaliser should identify itself when publishing its quotes through a trading venue or a data reporting service?**

<ESMA\_QUESTION\_146>

AFME Response

No, AFME strongly disagrees. A systematic internaliser (SI) should not have to identify itself when publishing its quotes through a trading venue or a data reporting service. An SI performs a significant and valuable function for investors by providing liquidity in a specific instrument. Unveiling the identity of the SI would put the committer of capital at undue risk and would give



away commercially sensitive information on flows. The publication of this information can be expected to disincentivise the SI from performing its function. We would also refer you to our answer to Q76 of the ESMA Discussion Paper where we also disagree with the proposal that the identity of the SI should be disclosed in post-trade reports.

<ESMA\_QUESTION\_146>

**Q147: Is there any other mean of communication that should be considered by ESMA?**

<ESMA\_QUESTION\_147>

AFME Response

No

<ESMA\_QUESTION\_147>

**Q148: Do you agree with the importance of ensuring that quotes published by investment firms are consistent across all the publication arrangements?**

<ESMA\_QUESTION\_148>

AFME Response

Yes

<ESMA\_QUESTION\_148>

**Q149: Do you agree with the compulsory use of data standards, formats and technical arrangements in development of Article 66(5) of MiFID II?**

<ESMA\_QUESTION\_149>

AFME Response

Yes

<ESMA\_QUESTION\_149>

**Q150: Do you agree with the imposing the publication on a 'machine-readable' and 'human readable' to investment firms publishing their quotes only through their own website?**

<ESMA\_QUESTION\_150>

AFME Response

Yes

<ESMA\_QUESTION\_150>

**Q151: Do you agree with the requirements to consider that the publication is 'easily accessible'?**



<ESMA\_QUESTION\_151>

AFME Response

Yes

<ESMA\_QUESTION\_151>

**4.2. Publication of unexecuted client limit orders on shares traded on a venue**

**Q152: Do you think that publication of unexecuted orders through a data reporting service or through an investment firm's website would effectively facilitate execution?**

<ESMA\_QUESTION\_152>

AFME Response

As per IMA response except where italics

It is AFME's view that publication of unexecuted orders through a data reporting service or through an investment firm's website would not effectively facilitate execution of client limit orders.

<ESMA\_QUESTION\_152>

**Q153: Do you agree with this proposal. If not, what would you suggest?**

<ESMA\_QUESTION\_153>

AFME Response

As per IMA response except where italics

It is AFME's view that publication of unexecuted orders through a data reporting service or through an investment firm's website would not effectively facilitate execution of client limit orders.

<ESMA\_QUESTION\_153>

**4.3. Reasonable commercial basis (RCB)**

**Q154: Would these disclosure requirements be a meaningful instrument to ensure that prices are on a reasonable commercial basis?**



<ESMA\_QUESTION\_154>

#### AFME Response

As per IMA response except where italics

As the Commission states in its mandate to ESMA, AFME considers that data charges in the EU are too high, particularly in comparison to the US. There is a clear public good argument for regulatory intervention on this issue.

Transparent disclosure by venues of their data pricing will be a valuable addition to constraining the rising costs of data across the EU. This measure will enable our members to compare the relative metrics per venue. Such enhanced transparency will act as a material break on increasing data costs.

*However, while such transparency may incentivise the stabilisation of costs, AFME is concerned that not one, nor a combination, of the options provides adequate confidence that costs could decrease from current too high levels.*

In addition, the AFME supports ESMA's proposition in the draft technical advice that the Commission should review the operation of the definition of reasonable commercial basis three years after its introduction. At that point it would be appropriate to review the outcomes provided by the market and consider whether a usable consolidated data stream has been created.

<ESMA\_QUESTION\_154>

**Q155: Are there any other possible requirements in the context of transparency/disclosure to ensure a reasonable price level?**

<ESMA\_QUESTION\_155>

#### AFME Response

- Unit of count policy (the strong preference is for the unit of count to be mandated as "natural user")
- Support and Development policy (the strong preference is for support development users to be free of charge)
- Volume discount policy
- Any other discount policy
- Fixed access fees prices
- Fixed Non Display fees price
- Cost of market data normalised for trading venue turnover



- Netting policy for multiple products e.g. top of the market netted again depth of market
- Standard products codes
- Entitlements codes for all major vendors

<ESMA\_QUESTION\_155>

**Q156: To what extent do you think that comprehensive transparency requirements would be enough in terms of desired regulatory intervention?**

<ESMA\_QUESTION\_156>

AFME Response

*As per IMA response except where italics*

As outlined in our response to Q154 above, transparency represents a valuable addition to the current landscape. However in isolation from other measures this will not result in the desired reduction in costs. AFME considers that additional transparency is a necessary but not sufficient condition to tackle excessive market data costs.

<ESMA\_QUESTION\_156>

**Q157: What are your views on controlling charges by fixing a limit on the share of revenue that market data services can represent?**

<ESMA\_QUESTION\_157>

AFME Response

*As per IMA response except where italics*

AFME considers that this is not the appropriate option. However the share of revenue that market data services represents is a useful indicator, when compared across venues. It is our view that this should be added to the list of metrics required to be published by venues on ESMA's website. This would also serve to highlight any outliers.

Those venues where market data services revenue is significantly out of line with their competitors would be forced to explain their model to market participants.<ESMA\_QUESTION\_157>

**Q158: Which percentage range for a revenue limit would you consider reasonable?**

<ESMA\_QUESTION\_158>

AFME Response

*As per IMA response except where italics*



As outlined in our response to Q157, each venue should be required to publish the share of revenue that market data services represents on the ESMA website. ESMA should not set a limit, publication of the figures themselves is sufficient.

<ESMA\_QUESTION\_158>

**Q159: If the definition of “*reasonable commercial basis*” is to be based on costs, do you agree that LRIC+ is the most appropriate measure? If not what measure do you think should be used?**

<ESMA\_QUESTION\_159>

AFME Response

Please see response to question 162 below

<ESMA\_QUESTION\_159>

**Q160: Do you agree that suppliers should be required to maintain a cost model as the basis of setting prices against LRIC+? If not how do you think the definition should be implemented?**

<ESMA\_QUESTION\_160>

AFME Response

As per IMA response except where italics

Yes we support this proposition. In addition venues should be required to have an external independent third party audit their figures on an annual basis to ensure they conform to both the spirit and letter of the regulations.

*Genuine price competition is a challenging area when specific data is only available from one source.* Transparency and high level principles are important aspects of improving the costs of market data services but are not sufficient in and of themselves.

<ESMA\_QUESTION\_160>

**Q161: Do you believe that if there are excessive prices in any of the other markets, the same definition of “*reasonable commercial basis*” would be appropriate, or that they should be treated differently? If the latter, what definition should be used?**

<ESMA\_QUESTION\_161>

AFME Response

As per IMA response except where italics

In order to enable cross market comparison, as outlined above, AFME considers that all venues should be required to publish relevant data pricing metrics in a consistent manner on the ESMA website.



<ESMA\_QUESTION\_161>

**Q162: Within the options A, B and C, do you favour one of them, a combination of A+B or A+C or A+B+C? Please explain your reasons.**

<ESMA\_QUESTION\_162>

### AFME Response

As per IMA response except where italics

*In the first instance AFME favours the introduction of a consolidated tape which includes pre and post trade information, that it is of the same quality as the constituent exchange data at a fee which is capped by the regulators.*

Market participants must be able to ascertain the variables used in the creation of the price being charged by the data providers. An important outcome of these proposals will be to limit the monopolistic behaviours of data providers and trading venues. *As noted in the response to question 154 above, current EU exchange fees for the construction of a pan-European view of the market is significantly higher than in the US and as such regulators should align these fees accordingly to the same level as currently established in the US.*

It is our view that with the reduction of transaction costs, trading venues will come to overtly rely on market data revenue to buttress their income without any improvements in service provision. *Regulators should have oversight on exchanges reaction to increase fees in other areas such as non-display usage or external redistribution to compensate loss of revenues from introduction of consolidated tape. In relation to the options presented by ESMA however, AFME considers that a combination of options A (additional transparency) +B (publication of revenue share) +C (implementation of LRIC) should be mandated by ESMA. Furthermore this should be combined with the FISD exchange matrix, therefore A+B+C +FISD. FISD is Financial Information Services Division of the Software & Information Industry Association. In 2013 an FISD Exchange Working Group (with the following participants: Barclays; BOA Merrill; BNY Mellon; BBH; Capital Group; Charles Schwab; Citi; Credit Suisse; Deutsche Bank; HSBC Morgan Stanley; Northern Trust; Northern Trust; RBC; Scotia; State Street; TD Ameritrade; UBS; Wells Fargo) agreed a list of items it would like all exchanges to offer.*

1. *Per User pricing*
2. *Direct reporting*
3. *3 year audit period*
4. *Volume discounts*
5. *Reasonable priced fixed fees (including Non-Display fees)*
6. *No charge for derived data*
7. *Free of charge support and development users (within a reasonable percentage)*



8. *Fee waiver for DMA (direct market access)*
9. *Consultation on T&C's*
10. *No subscriber agreements (the end user of the market data does not have to sign an agreement)*
11. *Clear reporting models (Simple reporting models (report the number of billable counts per product per billing account number))*
12. *Enterprise coverage*
13. *No indirect data feed charges*

*The current pricing for exchange market data can be considered to be supplied on a 'reasonable commercial basis' if all items on the FISD exchange matrix are offered by the exchange.*

<ESMA\_QUESTION\_162>

**Q163: What are your views on the costs of the different approaches?**

<ESMA\_QUESTION\_163>

AFME Response

Option A would not be costly as most exchanges currently publish products prices on their own websites. It could become more costly if exchange product prices also had to be maintained on a third party website eg ESMA website. Option B and Option B because of their inherent complexity are likely to be costly to administer.

<ESMA\_QUESTION\_163>

**Q164: Is there some other approach you believe would be better? Why?**

<ESMA\_QUESTION\_164>

AFME Response

Please see response to question 162 above

<ESMA\_QUESTION\_164>

**Q165: Do you think that the offering of a 'per-user' pricing model designed to prevent multiple charging for the same information should be mandatory?**

<ESMA\_QUESTION\_165>

AFME Response

Yes. This is an element of the FISD exchange matrix which we fully support.



<ESMA\_QUESTION\_165>

**Q166: If yes, in which circumstances?**

<ESMA\_QUESTION\_166>

AFME Response

Please see response to question 165 above

<ESMA\_QUESTION\_166>



## 5. Micro-structural issues

### 5.1. Algorithmic and high frequency trading (HFT)

#### Q167: Which would be your preferred option? Why?

<ESMA\_QUESTION\_167>

#### AFME Response

AFME is of the view that neither option is particularly fit for purpose. Both options, particularly on a stand-alone basis are not sufficiently targeted and take account neither of:

- 1) The definition at level 1 that a high-frequency algorithmic trading technique is characterised by “system determination of order initiation, generating, routing or execution without human intervention for individual trades or orders” or
- 2) ESMA’s own assertion that “HFT specifically monitors the market for patterns that indicate trading opportunities; then places orders to take instant advantage of those opportunities. HFT systems place automated, (usually) small scale, probabilistic bets (e.g. puts orders on both directions, buy and sell).

AFME is concerned that the tests proposed under option 2 do not meet the objective of carving out High Frequency Algorithmic Trading as a sub-set of algorithmic trading. AFME is particularly concerned that given the increasing interest in High Frequency Trading (HFT), the definition and tests proposed by ESMA will be referred to by other pieces of legislation or in any other legal context. It is therefore vital that the tests do not arbitrarily catch activities that do not match the intention of the definition. This is not the case with either of the proposed options.

By way of example, regarding option 1, many firms make use of co-location facilities and fast connections to give their institutional clients equality of access to financial markets. The final test of 75,000 messages is met by most large brokerage houses when executing on pan-European venues purely as a result of market-share. As automated trading technology becomes more uniform and useful to the broader public, an average message rate of two messages per second will most likely become irrelevant and superfluous.

Regarding option 2; AFME’s key concern is that a participant can have no certainty as to their status and cannot influence it regardless of whether they meet the spirit of the definition or not: Classification as “High Frequency” depends solely on the standing of the firm relative to other participants.

AFME would strongly urge ESMA to consider the options presented with a view to the following suggestions:

- 1) To ensure that the intention to separate “High Frequency Algorithmic Trading” from “Algorithmic Trading” is realised, there should be a test that both the initiation of the investment-decision and the implementation of that decision (to send an order to a trading venue) should be fully automated and synchronous.
- 2) AFME recommends further combining the tests for high intraday message rates within Option 1 and Option 2 such that both should be met.

3) If Option2 is to be considered or used as a test, AFME suggests that:

- a. It should be made clear that in calculating median lifetime of orders it is only those orders that rest on the market that are relevant.
- b. Any categorization using median resting time of orders needs refined to avoid forcing a classification of HFT onto participants on a market where there is in fact no such activity present. In current form the faster half of orders are potentially seen as HFT without any test as to whether they are in fact fast. The threshold below which orders should be deemed to be HFT via Option2 should therefore be refined to be the lower of the median time or 500 milliseconds.

For Options 1 and 2, the calculations should exclude the activity directly associated with market makers who are subject to a Continuous Quoting Obligation (CQO) for a proportion of a trading venue's trading hours that have entered into a binding written agreement as required under Article 17(3) MiFID as the orders/quotes are entered with the purpose of providing additional liquidity, i.e., marketable order-types with intention to be executed and matched by other members of the trading venue seeking liquidity.

## **FOREIGN EXCHANGE**

For the Microstructural Issues section of the Consultation Paper, unless the GFXD has submitted a specific response for FX, the GFXD supports the submissions made by the Association for Financial Markets in Europe (AFME).

<ESMA\_QUESTION\_167>

**Q168: Can you identify any other advantages or disadvantages of the options put forward?**

<ESMA\_QUESTION\_168>

### AFME Response

AFME reiterates the concerns raised in response to question 167 above. In addition:

On Option 1, AFME believes that the proposed 2 messages per second intraday message rate is too low, particularly if the assessment is not made at a strategy level.. A market participant may trade a lot in a specific market, or a market may have a broader range of instruments in which to trade, and either or both instances may result in a volume of messages that could satisfy the message rate hurdle without necessarily a high-frequency strategy being employed.

AFME's concern on the use of Option 2 on its own is that in looking a duration of an order rather than frequency of orders to fills does not target a true characteristic of the types of HFT that cause regulatory concern. A median used in this way would deem those below the median always HFT even in a market where no participants are using HFT strategies.

Please see further comment at question 169 below.

<ESMA\_QUESTION\_168>

**Q169: How would you reduce the impact of the disadvantages identified in your preferred option?**

<ESMA\_QUESTION\_169>

### AFME Response

Referring to the response in question 167 above AFME proposes that Option 1 and Option 2 should be used together and would recommend that in option 2 the test be to use whichever is the lower of the median or 500 milliseconds.

Referring to the wording of Option 1, Article 2(1)(d)(iii) of MiFID 2 requires that persons which deal on own account using a high frequency algorithmic trading technique are subject to authorisation as investment firms. Firms which pursue a high frequency trading strategy (thereby having a high intraday messaging rate) are normally dealing on own account; similarly other firms may have a high intraday messaging rate due to market making activity and to the volume of their client orders. We are proposing that ESMA includes the “dealing on own account” requirement as an additional requirement in (ii) of Option 1 of the Draft Technical Advice. This would ensure that investment firms executing client orders (which are already authorised by virtue of their brokerage activity) would not include in their calculation of intraday messages those which are due to client facilitation. For Options 1 and 2, the calculations should exclude the activity directly associated with market makers who are subject to a Continuous Quoting Obligation (CQO) for a proportion of a trading venue’s trading hours that have entered into a binding written agreement as required under Article 17(3) MiFID as the orders/quotes are entered with the purpose of providing additional liquidity, i.e. marketable order-types with intention to be executed and matched by other members of the trading venue seeking liquidity. ESMA already defined in the Short Selling Regulation that market making covers both client facilitation and providing continuous quotes during trading sessions and associated hedging of the 2 activities. The wording should therefore be amended to read “ii. The participant / member has “high message intraday rates” when at least 2 messages per second generated through dealing on own account are submitted to the trading venue over the trading day.”

Furthermore, we believe that a high frequency trading strategy pursued by a firm in relation to part of its business should not characterise the entire firm as a high frequency trading firm. Such a proposal overlooks the complexity of modern firms which may offer a variety of services out of the same legal entity. It would also dilute the regulatory focus which the characterisation as “high frequency trading” is designed to bring about on the high frequency trading activity itself. Regulators would be required to examine in the same framework data which is completely unrelated to high frequency trading.

<ESMA\_QUESTION\_169>

**Q170: If you prefer Option 2, please advise ESMA whether for the calculation of the median daily lifetime of the orders of the member/participant, you would take into account only the orders sent for liquid instruments or all the activity in the trading venue.**

<ESMA\_QUESTION\_170>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_170>

**Q171: Do you agree with the above assessment? If not, please elaborate.**

<ESMA\_QUESTION\_171>

#### AFME Response

AFME feels strongly that while a market participant may be active on one large platform that it does not follow that it would be so on all markets and therefore disagrees with ESMA's assessment. Furthermore, we believe that a high frequency trading strategy pursued by a firm in relation to part of its business should not characterise the entire firm as a high frequency trading firm. Such a proposal overlooks the complexity of modern firms which may offer a variety of services out of the same legal entity. It would also dilute the regulatory focus which the charac-



terisation as “high frequency trading” is designed to bring about on the high frequency trading activity itself. Regulators would be required to examine in the same framework data which is completely unrelated to high frequency trading.

<ESMA\_QUESTION\_171>

## 5.2. Direct electronic access (DEA)

**Q172: Do you consider it necessary to clarify the definitions of DEA, DMA and SA provided in MiFID? In what area would further clarification be required and how would you clarify that?**

<ESMA\_QUESTION\_172>

### AFME Response

Yes. AFME considers scope of Direct Electronic Access (DEA) should be extended from pure Sponsored Access (SA) to include (SA) and Direct Market Access (DMA) services. In line with Level 1 text DMA services are transmitted "directly" and therefore defined as where an order is submitted to a trading venue by the DMA user with the absence of any discretion from the direct member/participant of the trading venue. In this flow, the DMA client would choose the venue, size, and price limit of the order which, having gone through the broker's mandatory risk controls, is submitted without delay to the trading venue and will be executed in line with these instructions.

We would not view flow that utilises a broker's algorithms, including smart order router, as being in the scope of DEA trading. In this instance, the broker maintains discretion in the execution of the order and would determine some combination of the venue, size, time and price of the execution. As such, the proposals around algorithmic trading would apply rather than those pertaining to DEA provision.<ESMA\_QUESTION\_172>

**Q173: Is there any other activity that should be covered by the term “DEA”, other than DMA and SA? In particular, should AOR be considered within the DEA definition?**

<ESMA\_QUESTION\_173>

### AFME Response

As per response to question 172 and given AOR orders are not subject to the discretion of member/participant but routed to a trading venue selected at the discretion of AOR user, AOR should be considered within the scope of DEA.

<ESMA\_QUESTION\_173>

**Q174: Do you consider that electronic order transmission systems through shared connectivity arrangements should be included within the scope of DEA?**

<ESMA\_QUESTION\_174>

### AFME Response

The definition of Shared Connectivity Arrangements / Common Connectivity Channel is unclear, e.g. Are Shared Connectivity arrangements limited to the infrastructure / network and/or software; interface between client/user and trading venue member/participant and/or interface between to trading venue member/participant and the trading venue?



If Shared Connectivity arrangements are out scope for DEA, then AFME requests ESMA to provide a clearer definition of such arrangements.

<ESMA\_QUESTION\_174>

**Q175: Are you aware of any order transmission systems through shared arrangements which would provide an equivalent type of access as the one provided by DEA arrangements?**

<ESMA\_QUESTION\_175>

AFME Response

No

<ESMA\_QUESTION\_175>

## 6. Requirements applying on and to trading venues

### 6.1. SME Growth Markets

**Q176: Do you support assessing the percentage of issuers on the basis of number of issuers only? If not, what approach would you suggest?**

<ESMA\_QUESTION\_176>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_176>

**Q177: Which of the three different options described in the draft technical advice box above for assessing whether an SME-GM meets the criterion of having at least fifty per cent of SME issuers would you prefer?**

<ESMA\_QUESTION\_177>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_177>

**Q178: Do you agree with the approach described above (in the box Error! Reference source not found.), that only falling below the qualifying 50% threshold for a number of three consecutive years could lead to deregistration as a SME-GM or should the period be limited to two years?**

<ESMA\_QUESTION\_178>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_178>

**Q179: Should an SME-GM which falls below the 50% threshold in one calendar year be required to disclose that fact to the market?**

<ESMA\_QUESTION\_179>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_179>

**Q180: Which of the alternatives described above on how to deal with non-equity issuers for the purposes of the “at least 50% criterion” do you consider the most appropriate? Please give reasons for your answer.**

<ESMA\_QUESTION\_180>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_180>

**Q181: Do you agree that an SME-GM should be able to operate under the models described above, and that the choice of model should be left to the discretion of the operator (under the supervision of its NCA)?**

<ESMA\_QUESTION\_181>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_181>



**Q182: Do you agree that an SME-GM should establish and operate a regime which its NCA has assessed to be effective in ensuring that its issuers are “appropriate”?**

<ESMA\_QUESTION\_182>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_182>

**Q183: Do you agree with the factors to which a NCA should have regard when assessing if an SME-GM’s regulatory regime is effective?**

<ESMA\_QUESTION\_183>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_183>

**Q184: Do you think that there should be an appropriateness test for an SME-GM issuer’s management and board in order to confirm that they fulfil the responsibilities of a publicly quoted company?**

<ESMA\_QUESTION\_184>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_184>

**Q185: Do you think that there should be an appropriateness test for an SME-GM issuer’s systems and controls in order to confirm that they provide a reasonable basis for it to comply with its continuing obligations under the rules of the market?**

<ESMA\_QUESTION\_185>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_185>

**Q186: Do you agree with** Error! Reference source not found., Error! Reference source not found. **or** Error! Reference source not found. Error! Reference source not found.?

<ESMA\_QUESTION\_186>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_186>

**Q187: Are there any other criteria that should be set for the initial and on-going admission of financial instruments of issuers to SME-GMs?**

<ESMA\_QUESTION\_187>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_187>

**Q188: Should the SME-GM regime apply a general principle that an admission document should contain sufficient information for an investor to make an informed assessment of the financial position and prospects of the issuer and the rights attaching to its securities?**

<ESMA\_QUESTION\_188>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_188>

**Q189: Do you agree that SME-GMs should be able to take either a ‘top down’ or a ‘bottom up’ approach to their admission documents where a Prospectus is not required?**

<ESMA\_QUESTION\_189>  
TYPE YOUR TEXT HERE



<ESMA\_QUESTION\_189>

**Q190: Do you think that MiFID II should specify the detailed disclosures, or categories of disclosure, that the rules of a SME-GM would need to require, in order for admission documents prepared in accordance with those rules to comply with Article 33(3)(c) of MiFID II? Or do you think this should be the responsibility of the individual market, under the supervision of its NCA?**

<ESMA\_QUESTION\_190>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_190>

**Q191: If you consider that detailed disclosure requirements should be set at a MiFID level, which specific disclosures would be essential to the proper information of investors? Which elements (if any) of the proportionate schedules set out in Regulation 486/2012 should be dis-applied or modified, in order for an admission document to meet the objectives of the SME-GM framework (as long as there is no public offer requiring that a Prospectus will be drafted under the rules of the Prospectus Directive)?**

<ESMA\_QUESTION\_191>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_191>

**Q192: Should the future Level 2 Regulation require an SME-GM to make arrangements for an appropriate review of an admission document, designed to ensure that the information it contains is complete?**

<ESMA\_QUESTION\_192>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_192>

**Q193: Do you agree with this initial assessment by ESMA?**

<ESMA\_QUESTION\_193>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_193>

**Q194: In your view which reports should be included in the on-going periodic financial reporting by an issuer whose financial instruments are admitted to trading on an SME-GM?**

<ESMA\_QUESTION\_194>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_194>

**Q195: How and by which means should SME-GMs ensure that the reporting obligations are fulfilled by the issuers?**

<ESMA\_QUESTION\_195>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_195>

**Q196: Do you think that the more generous deadlines proposed for making reports public above (in the Box above, paragraph Error! Reference source not found.) are suitable, or should the deadlines imposed under the rules of the Transparency Directive also apply to issuers on SME-GMs?**

<ESMA\_QUESTION\_196>





TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_196>

**Q197: Do you agree with this assessment that the MiFID II framework should not impose any additional requirements/additional relief to those envisaged by MAR?**

<ESMA\_QUESTION\_197>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_197>

**Q198: What is your view on the possible requirements for the dissemination and storage of information?**

<ESMA\_QUESTION\_198>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_198>

**Q199: How and by which means should trading venues ensure that the dissemination and storage requirements are fulfilled by the issuers and which of the options described above do you prefer?**

<ESMA\_QUESTION\_199>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_199>

**Q200: How long should the information be stored from your point of view? Do you agree with the proposed period of 5 years or would you prefer a different one (e.g., 3 years)?**

<ESMA\_QUESTION\_200>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_200>

**Q201: Do you agree with this assessment that the MiFID II framework should not impose any additional requirements to those presented in MAR?**

<ESMA\_QUESTION\_201>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_201>

## **6.2. Suspension and removal of financial instruments from trading**

**Q202: Do you agree that an approach based on a non-exhaustive list of examples provides an appropriate balance between facilitating a consistent application of the exception, while allowing appropriate judgements to be made on a case by case basis?**

<ESMA\_QUESTION\_202>

### AFME Response

AFME agrees that this should be a non-exhaustive list.

<ESMA\_QUESTION\_202>



**Q203: Do you agree that NCAs would also need to consider the criteria described in paragraph Error! Reference source not found. Error! Reference source not found. and Error! Reference source not found., when making an assessment of relevant costs or risks?**

<ESMA\_QUESTION\_203>

AFME Response

AFME agrees that this should be a non-exhaustive list.

<ESMA\_QUESTION\_203>

**Q204: Which specific circumstances would you include in the list? Do you agree with the proposed examples?**

<ESMA\_QUESTION\_204>

AFME Response

Yes

<ESMA\_QUESTION\_204>

### **6.3. Substantial importance of a trading venue in a host Member State**

**Q205: Do you consider that the criteria established by Article 16 of MiFID Implementing Regulation remain appropriate for regulated markets?**

<ESMA\_QUESTION\_205>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_205>

**Q206: Do you agree with the additional criteria for establishing the substantial importance in the cases of MTFs and OTFs?**

<ESMA\_QUESTION\_206>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_206>

### **6.4. Monitoring of compliance – information requirements for trading venues**

**Q207: Which circumstances would you include in this list? Do you agree with the circumstances described in the draft technical advice? What other circumstances do you think should be included in the list?**

<ESMA\_QUESTION\_207>



TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_207>

## **6.5. Monitoring of compliance with the rules of the trading venue - determining circumstances that trigger the requirement to inform about conduct that may indicate abusive behaviour**

**Q208: Do you support the approach suggested by ESMA?**

<ESMA\_QUESTION\_208>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_208>

**Q209: Is there any limitation to the ability of the operator of several trading venues to identify a potentially abusive conduct affecting related financial instruments?**

<ESMA\_QUESTION\_209>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_209>

**Q210: What can be the implications for trading venues to make use of all information publicly available to complement their internal analysis of the potential abusive conduct to report such as managers' dealings or major shareholders' notifications)? Are there other public sources of information that could be useful for this purpose?**

<ESMA\_QUESTION\_210>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_210>

**Q211: Do you agree that the signals listed in the Annex contained in the draft advice constitute appropriate indicators to be considered by operators of trading venues? Do you see other signals that could be relevant to include in the list?**

<ESMA\_QUESTION\_211>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_211>

**Q212: Do you consider that front running should be considered in relation to the duty for operators of trading venues to report possible abusive conduct? If so, what could be the possible signal(s) to include in the list?**

<ESMA\_QUESTION\_212>  
TYPE YOUR TEXT HERE  
<ESMA\_QUESTION\_212>

## 7. Commodity derivatives

### 7.1. Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II

**Q213: Do you agree with ESMA's approach on specifying contracts that "must" be physically settled and contracts that "can" be physically settled?**

<ESMA\_QUESTION\_213>

#### AFME Response

We agree that it is necessary to establish criteria to enable market participants to distinguish between contracts that "must" be physically settled and contracts that "can" be physically settled. The criteria for determining the contracts that "must" be physically settled will be relevant only for the purposes of the carve-out from section C(6) and the definition of "C(6) energy derivative contracts", while the criteria for contracts which "can" be physically settled will be more generally relevant for determining which contracts fall within sections C(6) and (7).

We would welcome confirmation from ESMA in its Technical Advice that contracts which are excluded from section C(6) should not also be required to be tested against the criteria in section C(7) and the related implementing regulation. We consider that it is clear from the text of MiFID II that only contracts "not otherwise mentioned in point 6 of this Section" should be considered under section C(7), so a contract which falls within the section C(6) carve-out should not be brought back within scope under section C(7).

As discussed further in our response to Q217, we consider that ESMA should continue to develop criteria to enable market participants to determine which contracts "must" be physically settled and which "can" be physically settled, rather than seeking to develop a list of concrete examples of types of contracts which "must" be physically settled. We consider that the application of criteria developed by ESMA would be an effective means of properly characterising a contract as "must be" or "can be" physically settled, but are concerned that characterising by reference to specific contracts set out in the regulations could inhibit the future development and evolution of contracts and contract documentation that is customary in these markets.

We provide our comments on ESMA's approach to specifying contracts that "must be" physically settled in our responses to Q215 and Q217. However, we note here that the Draft Technical Advice provides little in the way of equivalent guidance on the interpretation of "can be" physically settled. To address this, we would particularly welcome clarification from ESMA on the meaning of the comments under paragraph 17(ii)(d) of section 7 of the CP.

<ESMA\_QUESTION\_213>

**Q214: Which oil products in your view should be caught by the definition of C6 energy derivatives contracts and therefore be within the scope of the exemption? Please give reasons for your view stating, in particular, any practical repercussions of including or excluding products from the scope.**

<ESMA\_QUESTION\_214>

#### AFME Response



Intentionally left blank.

<ESMA\_QUESTION\_214>

**Q215: Do you agree with ESMA's approach on specifying contracts that must be physically settled?**

<ESMA\_QUESTION\_215>

AFME Response

Paragraph 1 of the Draft Technical Advice (on page 282 of ESMA's CP) sets out criteria for determining contracts that must be physically settled. As drafted the provision appears to apply to physically settled contracts in all commodity asset classes, whereas ESMA's supporting analysis appears to be considering physically settled contracts in power, gas, coal and oil only (see paragraphs 8-9).

We recommend that paragraph 1 of the Draft Technical Advice be amended to clarify that this advice applies only for the purposes of further specifying wholesale energy products under Section C(6) and C(6) energy derivative contracts. For example:

**"1. For the purposes of further specifying wholesale energy products under Section C(6) and C(6) energy derivative contracts, contracts must be physically settled if [...]"**

We support the general principle of the proposed paragraph 1(i) of the Draft Technical Advice.

We support the general principle of the proposed paragraph 1(ii) of the Draft Technical Advice. However, it would be helpful if the language was consistent with that used in the Level 1 text. For example, "the contract may not be settled in cash at the option of any of the parties other than by reason of default or other termination event".

We do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes other than power and gas.

We support ESMA's proposal that the existence of force majeure provisions should not prevent a contract from being characterised as "must be physically settled". Force majeure is a widely understood and widely used legal principle. The events of force majeure will be agreed by the parties in respect of the particular transaction and documented in the relevant agreement. Standard trading agreements also commonly include force majeure provisions.

We support ESMA's proposal that the existence of "other bona fide clauses rendering it impossible to perform the contract on a physical settlement basis" should not prevent a contract from being characterised as "must be physically settled". This is not a widely used legal principle and so some further guidance from ESMA will be required. We suggest default and other termination events should be considered at first instance.

See also our response to Q218 in which we state that a "bona fide inability to settle" may arise as a result of an event of default or other termination events specified in the relevant contract. It is important that any guidance regarding what would constitute a "bona fide inability to settle" should not exclude events of default specified in the relevant contract, as this could lead to a situation in which the parties to the contract are unable to settle physically, but the contract is not considered to be one which must be settled physically. We also reiterate that the examples we

have provided are not intended to provide an exhaustive list, as the point of these clauses is to address unforeseen events and specifying an exhaustive list would defeat this point.

We understand that the list of delivery methods which would be considered to be physical delivery set out in paragraph 4(i) of the Draft Technical Advice is a non-exhaustive list and we agree that is an appropriate approach. However, we would welcome further consultation on any proposed definition of what is meant by "physically settled". There are many different ways in which physical settlement can be made, depending on the type of market. It will be critically important for these markets to ensure that any proposed definition of "physically settled" remains a non-exhaustive list (as currently proposed by ESMA), because if the list is an exhaustive list and any particular method of delivery is not included in the list (for any reason, including inadvertently) there is a risk that the contract will no longer be considered to be physically settled, and so must be considered to be cash settled. In addition, if the list were to be an exhaustive list any definition would need to be sufficiently flexible to envisage new products with new methods of physical settlement, to avoid an argument that new types of contracts should be automatically categorised as C(5) contracts where the relevant method of physical delivery is not included in the list.

In relation to paragraph 4(i) of the Draft Technical Advice, we would recommend clarifying that the advice applies to derivative contracts relating to commodities and replacing the references to "relevant goods" with "relevant commodities" (as "goods" is not a term defined under MiFID II and as all these provisions relate to commodity derivatives).

We would also propose revising paragraph 4(ii) so that it reflects a more generally applicable concept of the transfer of ownership rights in a commodity. Although the concept of title transfer is a primary focus in physical markets such as coal and oil, markets such as power and gas tend to focus more on delivery and acceptance obligations which occur at the delivery point. However, in all cases the result is a transfer of a right of an ownership nature. We would propose the following amendment:

**"~~delivery of a document giving rights~~ transfer of a right of an ownership nature to the relevant ~~goods~~ commodity or the relevant quantity of the ~~goods~~ commodity concerned (such as by delivery of a document, e.g. a confirmation from the power or gas market operator, a bill of lading or a warehouse warrant);"**

We would also recommend including book entry as an example of another method of bringing about the transfer of rights of an ownership nature under paragraph 4(iii), as this is a common method of transfer of rights in relation to markets such as precious metals or uranium.

<ESMA\_QUESTION\_215>

**Q216: How do operational netting arrangements in power and gas markets work in practice? Please describe such arrangements in detail. In particular, please describe the type and timing of the actions taken by the various parties in the process, and the discretion over those actions that the parties have.**

<ESMA\_QUESTION\_216>

#### AFME Response

We believe that a detailed explanation of operational netting arrangements in power and gas markets is necessary and useful to the extent that there is explicit reference in the technical advice that such arrangements do meet the requirements for contracts that 'must be' physically settled as we suggest in response to Q215.

For reference, under Q215 we stated that we do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes.

Physically settled transactions in gas or power involve the delivery of the underlying commodity and the change in the ownership of the commodity. These contracts include forward contracts (for delivery at some point in the future) and spot products (where delivery is within a shorter time period).

The operational arrangements for delivery in gas and power markets may produce an offset of physical deliveries, however no netting takes place between contracts or transactions that can be considered equivalent to cash settlement or offset of transactions: the obligation under each individual contract to physically deliver and transfer rights of title is legally binding and enforceable, excluded only under specific circumstances (e.g. force majeure, default of due payment or inadequate performance).

In gas and power physical markets, participants have to enter into contractual arrangements with system operators of transportation pipelines/transmission lines in order to become network/system users and being able to deliver to wholesale counterparties or retail consumers the energy produced or acquired. Network codes and the technical annexes are the main contractual and operational documents regulating the relationship between network/system users (or market participants) and the Transmission System Operators (TSOs).

Market participants may have direct access to energy production facilities (e.g. power plant) or may acquire energy from other market participants. The acquisition (and sales) of energy at wholesale level takes place through contractual agreements (e.g. EFET master agreements) which stipulate the obligation for the selling party to a transaction to physically deliver and transfer the rights of title in the respective commodity and the obligation of the buying party to accept such delivery and transfer of title.

A market participant buys and/or sell gas or power for delivery in a specific day or hour at a specific trading point several times with several counterparties over time before the actual delivery, depending on the portfolio of their commercial activities (e.g. production of energy, sales of energy) and a series of factors (e.g. weather forecast, price forecasts, availability of infrastructures etc.). In order to manage risks related to the availability of the underlying and price fluctuations, transactions may be entered into also many years ahead of the period of delivery. Therefore a certain amount of uncertainty about the final amount of energy required is implicit for all market participants in gas and power markets, and this activity is normal in the necessary course of business for physically settled transactions.

However, when approaching the delivery period, market participants are required to balance inputs and outputs in the energy network on a relevant period basis (e.g. hourly or daily), hence an obligation applies to submit nominations of inputs and outputs for each trading point where the market participant is active. Nominations must be entered into TSOs' systems within the deadlines defined in operational rules (e.g. 2 PM on the day before the 'delivery period' starts).

Such nominations include the inputs from energy infrastructures directly owned or possessed by a market participant and the energy acquired (or sold) over time through forward contracts traded in multiple ways.

Therefore in gas and power markets, delivery is performed by submitting the schedules of the injections into/withdrawals from the energy system and the transactions with other wholesale counterparties to the operator of the designated trading point. These nominations may be required for each contract and/or facility or aggregated (total inputs and outputs for a single market area).

TSOs or service providers, who are responsible for the management and operations of the physical transportation networks, process the information received and match the schedules submitted by each market participant to ensure that the instructions of sellers and buyers are consistent in order to take into account the flows required by each network user (or group of network users). Any inconsistency must be rectified before the delivery period occurs.

In case market participants have more than one trade of opposite 'sign' (buy and sell) between them at a particular trading point/area and for the same delivery period, schedules or nominations may be required to be submitted on a net basis for administrative convenience i.e. to avoid the need for the operator to aggregate and handle multiple nominations.

In the daily activity of submitting nominations/schedules to system operators all individual contracts traded either on platforms or bilaterally are physical for settlement purposes. In the period following the actual flows (a few days or months), the TSOs and service providers calculate the energy inputs and outputs attributable to each network user for each relevant period, and differences between the final nominations and the actual intakes/offtakes are charged at a specific 'balancing price'. The balancing price is usually structured in a way to incentivise network users to stay 'in balance' during each period. This ensures that inputs and outputs of the system are commercially and physically balanced.

In any case, such arrangements do not involve the netting of contracts or transactions in the sense that the term "netting" is used in financial markets. The offset of deliveries may be merely the result of the schedules submitted to system operators: the submission of nominations according to the operational rules provided by system operators is the way in which counterparties perform the obligation to settle physically their contracts. By contrast, contracts that are not for physical settlement do not require entering into contractual arrangements with system operators, do not require the need to register contracts with system operators, do not require the submission of schedules and are not subject to balancing rules. These are substantial differences.

<ESMA\_QUESTION\_216>

**Q217: Please provide concrete examples of contracts that must be physically settled for power, natural gas, coal and oil. Please describe the contracts in detail and identify on which platforms they are traded at the moment.**

<ESMA\_QUESTION\_217>

#### AFME Response

We consider that ESMA should continue to develop criteria to enable market participants to determine which contracts "must" be physically settled and which "can" be physically settled, rather than seeking to develop a list of concrete examples of types of contracts which "must" be physically settled. In developing these criteria regard should be given to industry practices.

For your information, we provide below a non-exhaustive list of the types of master agreements/industry standard agreements currently used in the market to trade power, natural gas, coal and oil for physical settlement:

- (i) EFET General Agreement;



- (ii) ISDA Master Agreement (1992/2002) with physical trading annexes (GTMA Transactions; NBP; ZBT);
- (iii) Grid Trade Master Agreement 2004 (GTMA);
- (iv) Trading Terms & Conditions Short Term Flat NBP 1997 (NBP 1997);
- (v) Zeebrugge Hub Natural Gas Trading Terms & Conditions (ZBT 2004);
- (vi) Zeebrugge Beach Natural Gas Trading Terms & Conditions (ZBT 2012);
- (vii) Standard Terms and Conditions for Sale and Purchase of Natural Gas for UK Short Term Deliveries at the Beach (Beach 2000);
- (viii) Standard Coal Trading Agreement (SCoTA);
- (ix) BP General Terms and Conditions for the Sales and Purchases of Crude Oil/Petroleum Products.

However, we should note that coal is also commonly traded under terms prepared by specific market counterparties and subsequently negotiated on a bilateral basis as between with trading counterparts. This means that coal terms can vary from trade to trade and as between trading counterparts. Oil is commonly traded under terms issued by the oil majors, for example the BP General Terms and Conditions referred to above.

For reference, under Q215 we stated that we do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties (i.e. to physically deliver and accept delivery) and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes.

By way of example, the EFET General Agreements for gas provide that, where the parties mutually agree to scheduling their receipts and deliveries on a net or offset basis and it is possible to do so at the relevant delivery point, then each party will have fulfilled its obligations to physically deliver the contract quantity for each individual contract entered into with the other party if it schedules to the network operator the aggregate net result of all contract quantities being bought and sold under all relevant individual contracts.

The EFET Gas Master also requires parties to confirm that at the time of entering into the relevant contract such individual contract will result in physical delivery and that scheduling on a net or offset basis is for administrative convenience only. Scheduling on a net or offset basis is market convention in these markets and is contemplated under master agreements such as the EFET Agreements. These obligations expressly apply to each individual transaction for the purchase and sale of the relevant commodity entered into under the EFET Agreements.

In order to fulfil such obligation of delivery the counterparties to a transaction are required to have a contractual relationship with operators of transmission systems or transportation networks and/or service providers responsible for the management and operations of the nomination platforms. Delivery is performed by submitting the schedules of the transactions on a net or offset basis (as described above) to the operator of the designated delivery point.

Under the EFET Agreements the obligation under each individual transaction entered into under the agreement to physically deliver and transfer rights of title and risk in the relevant commodity is legally binding and enforceable. A contracting party is only released from such obligation in case of force majeure (delivery may also not occur in the case of a counterparty default, e.g., as a

result of failure to make a due payment or delivery or inadequate performance assurance or credit support document, giving rise to early termination). A transaction can be terminated early by a non-defaulting party in such circumstances, but contracting parties will have obligations as a result of that default or termination (e.g. an obligation to pay an early termination amount).

There is no 'cash out' or 'book out' option in power and gas trading whereby either party can at its option elect to pay or receive cash settlement in lieu of delivery of the commodity. Payment or receipt of cash to the other party in lieu of physical delivery can happen only under power and gas trades in case of default or termination of the contract as described above, or in some cases for a non-material failure to deliver or accept (power) or in case of under delivery, under acceptance, over delivery or over acceptance (natural gas), in which case liquidated damages would be payable for that particular delivery, or by separate subsequent agreement of the parties.

We also note that, while the EFET Agreements do not permit a party to elect cash settlement in lieu of delivery or receipt, individual transactions entered into under these master agreements can be subject to operational netting arrangements, which we discuss in more detail in our response to Q216 and which we do not consider would prevent a contract from being characterised as "must be physically settled".

In addition to the examples of contracts for power and gas transactions described above, we set out below examples of methods of physical settlement in relation to coal that is physically settled, including:

- (i) FOB (Free on Board) – title/risk pass on loading, payment is affected after completion of loading and receipt of documents (Bill of Lading, Certificate of Analysis etc.)
- (ii) CIF (Cost, Insurance and Freight) - title/risk pass on loading, payment is affected after completion of loading and receipt of documents (Bill of Lading, Certificate of Analysis etc.)
- (iii) CFR (Cost and Freight) – same as CIF
- (iv) DAT (Delivered at Terminal) – title/risk pass on arrival at discharge port, payment is affected after completion of discharge and receipt of documents (Draft Survey, Certificate of Analysis etc.)
- (v) DAP (Delivered at Place) – same as DAT but includes further delivery possibly by barge or train
- (vi) EXW (Ex Works) – title/risk pass when tonnage is made available to buyer, initial payment is affected following completion of buyer lifting cargo or at the end of the month of delivery if not lifted during contract month, final payment is affected upon completion of loading and receipt of documents (barge/train lifting docs, Certificate of Analysis, Invoice)
- (vii) DES (Delivered ex Ship) – was removed from previous Incoterms version (replaced by DAT) but still traded regularly.

There are other types of delivery but these are less commonly traded in coal (if at all). All of the above are subject to contract terms.

SCoTA is the industry recognised contract for a number of products with the most actively traded being DES ARA, FOB Richards Bay, FOB Newcastle and to a lesser extent FOB Colombia. Transactions under the SCoTA are from time to time cash settled in lieu of delivery, but as with the EFET Agreements cash settlement is not an option provided by the SCoTA but would be separately negotiated by the parties subsequent to their entering into the original transaction and in specific circumstances (i.e., where all parties in a relevant chain agree to cash settle). ESMA's

Technical Advice should distinguish this situation from a situation where the relevant contract would fall within section C(5) as a contract which may be settled in cash at the option of one of the parties.

- Bookouts – where a party has a long and short position with the same client, the parties may agree to offset physical obligations and net settle the difference between contract prices for the volume bought and sold (however, again this would be subject to mutual consent in specific circumstances by the parties subsequent to their entering into the original transaction).
- Circle outs / close-outs – same as a bookout but with more than 2 parties involved and the value is settled as the following example:
  - Party A sells 50,000mt FOB Richards Bay to Party B at \$80.00 in August 14
  - Party B sells 50,000mt FOB Richards Bay to Party C at \$85.00 in August 14
  - Party C sells 50,000mt FOB Richards Bay to Party A at \$90.00 in August 14
  - The Parties agree that there is a circle and to offset the physical obligations from each other and to settle the contract prices against API4 for August 14
  - API4 for August 14 outturns at \$82.00, therefore:
    - Party A pays Party B \$100,000 (50,000 \* minus \$2 pmt)
    - Party C pays Party B \$150,000 (50,000 \* \$3 pmt)
    - Party A pays Party C \$400,000 (50,000 \* \$8 pmt)

<ESMA\_QUESTION\_217>

**Q218: How do you understand and how would you describe the concepts of “force majeure” and “other bona fide inability to settle” in this context?**

<ESMA\_QUESTION\_218>

#### AFME Response

Although the meaning of "force majeure" may differ in light of the relevant governing law and the express provisions of the relevant contract, force majeure is essentially the means by which parties allocate the risk of unforeseen events which adversely affect their ability to perform contractual obligations. In this context, the concept of force majeure can be intended as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome which was not foreseeable at the time that the contract was entered into, and which hinders, delays or prevents performance of obligations according to the contract terms. In case of gas and power markets this may include failure of communication or IT systems of the relevant network or system operator or an unplanned outage. The party affected by force majeure is generally under a duty to attempt to resolve the force majeure event. In certain circumstances, no breach or default is deemed to have occurred and the counterparty claiming the force majeure is released from the contractual obligations for the period of time that force majeure prevents its performance. The consequences of the force majeure event will depend on the nature and terms of the contract, but they typically include suspension of performance, a reduction or cancellation of obligations or the cancellation of the contract if the force majeure event continues beyond an agreed period.

*Other bona fide inability* may include failure to pay or inadequate performance assurance or credit support document or cases of early termination due to specific circumstances such as the insolvency of a counterparty, but also other events that do not entail a fault of one of the parties



to perform according to its obligations (e.g. a change in law preventing a counterparty from transacting in the relevant asset class or jurisdiction).

It is important that any guidance regarding what would constitute a "bona fide inability to settle" should not exclude events of default specified in the relevant contract, as this could lead to a situation in which the parties to the contract are unable to settle physically (e.g. as a result of the insolvency of one party), but the contract is not considered to be one which must be settled physically.

The examples provided above should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is that they can be sufficiently broad to accommodate unforeseen events. Any attempt to define such cases in a granular way for all commodities would lead to additional legal uncertainty because the operational arrangements and practices in commodity markets differ extensively.

<ESMA\_QUESTION\_218>

**Q219: Do you agree that Article 38 of Regulation (EC) No 1287/2006 has worked well in practice and elements of it should be preserved? If not, which elements in your view require amendments?**

<ESMA\_QUESTION\_219>

#### AFME Response

We agree that Article 38 of the MIFID Implementing Directive has worked well in practice to date. We acknowledge that this provision will require revision to take account of the changes to the scope of financial instruments under MIFID II, particularly the introduction of the OTF trading venue.

However, we strongly disagree with the proposed changes to (i) the trading criterion under Article 38(1) (see our response to Q224, which sets out our opinion that deleting "expressly stated to be" from the equivalence test actually reduces the objectivity of the test rather than increasing it as ESMA intends) and to (ii) the clearing criterion (see our response to Q222, which sets out our opinion that deleting the clearing criterion is likely to have the effect of removing contracts from the scope of EMIR, as the definition of "derivative" under EMIR is based on that under MiFID II. EMIR on its own does not bring additional contracts within scope of the clearing obligation unless they are already within scope of MiFID II).

We would strongly encourage ESMA not to finalise its Technical Advice on the definition of financial instruments in advance of final policy proposals on the position limits regime and ancillary activities exemption. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

We support ESMA's clarification in paragraph 22 of section 7 that the criteria for determining whether or not a contract has the characteristics of other derivative instruments should be applied cumulatively and would welcome a similar statement in the final Technical Advice.

<ESMA\_QUESTION\_219>

**Q220: Do you agree that the definition of spot contract in paragraph 2 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose?**

<ESMA\_QUESTION\_220>

#### AFME Response

We agree that the definition of "spot" is still valid and that it should become part of the future implementing measures for MiFID II.

While the flexibility of the definition gives rise to the possibility of differing interpretations in different Member States, we consider that it would be more appropriate to address any differences through guidance rather than by amending the definition in the legislation. Commodity markets are very diverse and seeking to define in legislation what would be a "spot" contract for every market, every type of underlying and every type of contract is likely to result in a definition which is inflexible and would not be able to respond to changes in the structure and practice of the markets or to be updated promptly to reflect changing market conditions.

For example, we are aware that in some cases market participants adopt different interpretations of "trading days" (e.g. banking days in the jurisdiction of the underlying commodity market, or banking days in the jurisdiction of the parties to the contract). It would be helpful for ESMA to clarify this issue in guidance to facilitate a consistent approach to implementation across the market.

We would also welcome confirmation from ESMA that the definition of "spot" provided in the context of section C(7) is generally applicable in relation to sections C(5) – C(10) and that spot contracts are not derivative financial instruments regardless of the underlying (as indicated in paragraph 29 of Section 7 of the Consultation Paper).

<ESMA\_QUESTION\_220>

**Q221: Do you agree that the definition of a contract for commercial purposes in paragraph 4 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose? What other contracts, in your view, should be listed among those to be considered for commercial purposes?**

<ESMA\_QUESTION\_221>

AFME Response

The definition of a contract for commercial purposes is still valid. We would not propose any changes to the definition.

<ESMA\_QUESTION\_221>

**Q222: Do you agree that the future Delegated Act should not refer to clearing as a condition for determining whether an instrument qualifies as a commodity derivative under Section C 7 of Annex I?**

<ESMA\_QUESTION\_222>

AFME Response

No, we do not agree

ESMA states in the CP that "in simplified terms, EMIR says that commodity derivatives as defined in MiFID I have to be cleared if certain conditions are fulfilled. If MiFID II were to then continue defining commodity derivatives as instruments which are (already) cleared, [...] this would establish a circularity between the two pieces of legislation". However, we do not consider that this would establish a circularity. The starting point for determining the scope of EMIR is the definition of "financial instrument" under MiFID. If a contract is not a derivative under MiFID, it will not be within the scope of EMIR.

The clearing obligation under EMIR does not require all derivative contracts to be cleared, but rather provides that certain derivative contracts which are already admitted to clearing may be

required to be cleared. In order to become subject to the clearing obligation, these contracts need to be "derivatives" as defined in EMIR (i.e., financial instruments under sections C(4) – (10) MiFID).

Removing the reference to clearing as a condition for determining whether or not an instrument qualifies as a commodity derivative under section C(7) may mean that some contracts which are cleared will no longer qualify as derivatives. If these cleared contracts no longer qualify as derivatives, they will no longer be within scope of EMIR and could not become subject to mandatory clearing.

We consider that the reference to clearing by a clearing house or having arrangements for payment or provision of margin add clarity to the scope of section C(7) and would not create circularity.

<ESMA\_QUESTION\_222>

**Q223: Do you agree that standardisation of a contract as expressed in Article 38(1) Letter c of Regulation (EC) No 1287/2006 remains an important indicator for classifying financial instruments and therefore should be maintained?**

<ESMA\_QUESTION\_223>

#### AFME Response

We agree that standardisation of a contract remains an important indicator and that it should be maintained. However, standardisation is not the only relevant indicator and it is important that standardisation continues to be considered together with the other factors set out in Article 38 of Regulation (EC) 1287/2006.

Standardisation of contract terms is common feature of market development. Efforts to enhance standardisation should be favoured because the use of standard terms reduces legal uncertainty and supports liquidity in the relevant markets.

<ESMA\_QUESTION\_223>

**Q224: Do you agree with the proposal to maintain the alternatives for trading contracts in Article 38(1)(a) of Regulation (EC) No 1287/2006 taking into account the emergence of the OTF as a MiFID trading venue in the future Delegated Act?**

<ESMA\_QUESTION\_224>

#### AFME Response

We strongly disagree with the proposed change to the third limb of the trading criterion from "*expressly stated to be equivalent to*" to "*equivalent to*".

We do not consider that the proposed test achieves ESMA's stated aim of a more objective test. Rather it introduces a subjective test under which the parties may adopt different positions on whether a contract is "equivalent". Any difference in regulatory treatment of a contract by the parties will result in significant practical compliance difficulties in the wider regime for regulation of derivatives (e.g. EMIR portfolio reconciliation and compression, reporting, clearing and collateral obligations).

The current test has worked well to date. The requirement for a contract to be "*expressly stated to be equivalent to*" a contract traded on a regulated market provides clarity for all market participants, as it is possible to establish whether or not this criterion is met by looking at the terms of the contract. The LME Look Alike Contract is a good example of a contract which is expressly stated to be equivalent to a contract traded on a regulated market (i.e. LME).

It is also unclear how ESMA's proposed "*equivalent to*" test would interact with the "economically equivalent" test under the position limits regime. This is a key concern given the inter-relationship between the scope of financial instruments and the position limits regime.

We understand that limiting the tests in paragraph 7(ii) of the Draft Technical Advice to, "*as far as contracts within the scope of C6 of Annex I Directive are concerned*" is intended to ensure that wholesale energy products traded on an OTF that must be physically settled which are carved out of C6 should not then be considered under C7. If so, we agree with this principle but would prefer that the issue to be dealt with in a separate specific paragraph in the Technical Advice to avoid any unintended consequences in interpretation of this provision going forward. See also our response to Q225.

<ESMA\_QUESTION\_224>

**Q225: Do you agree that the existing provision in Article 38(3) of Regulation (EC) No 1287/2006 for determining whether derivative contracts within the scope of Section C(10) of Annex I should be classified as financial instruments should be updated as necessary but overall be maintained? If not, which elements in your view require amendments?**

<ESMA\_QUESTION\_225>

AFME Response

We agree that the existing provision in Article 38(3) should be maintained as it currently stands, except that it should be updated as necessary to reflect the introduction of OTFs as a new category of trading venue.

We also recommend that ESMA reconsider paragraph 11(ii)(c) of the Draft Technical Advice.

We understand that specifying contracts that are traded on an OTF "if the contract is within the scope of C6 of Annex I" is intended to ensure that wholesale energy products traded on an OTF that must be physically settled which are carved out of C6 should not then be considered under C10. If so, we agree with this principle but would prefer that the issue to be dealt with in a specific paragraph in the Technical Advice. The current drafting appears to operate so that any derivative with a C10 underlying traded on an OTF will be excluded from C10 as it cannot, by definition, be within scope of C6. This does not appear to be the policy intention.

<ESMA\_QUESTION\_225>

**Q226: Do you agree that the list of contracts in Article 39 of Regulation (EC) No 1287/2006 should be maintained? If not, which type of contracts should be added or which ones should be deleted?**

<ESMA\_QUESTION\_226>

AFME Response

Intentionally left blank.

<ESMA\_QUESTION\_226>

**Q227: What is your view with regard to adding as an additional type of derivative contract those relating to actuarial statistics?**

<ESMA\_QUESTION\_227>

AFME Response

Intentionally left blank.



<ESMA\_QUESTION\_227>

**Q228: What do you understand by the terms “reason of default or other termination event” and how does this differ from “except in the case of force majeure, default or other bona fide inability to perform”?**

<ESMA\_QUESTION\_228>

#### AFME Response

The terms ‘by reason of default or other termination event’ should be understood differently from force majeure and a subset of the general case of bona fide inability to perform.

In this context the concept of force majeure should be intended as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome and which it makes impossible for one of the parties to perform according to the contract terms. *Default or termination events* may be specific cases of inability to perform of one of the counterparties, however other *inabilities to perform* may include also other cases like inadequate performance assurance or credit support documentation that determines the inability to perform the contract.

In any case we reiterate our view that these examples should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is to remain sufficiently broad to accommodate unforeseen events. Any attempt to define these cases in a granular way for all commodities would lead to additional legal uncertainty.

<ESMA\_QUESTION\_228>

## **7.2. Position reporting thresholds**

**Q229: Do you agree with the proposed threshold for the number of position holders? If not, please state your preferred thresholds and the reason why.**

<ESMA\_QUESTION\_229>

#### AFME Response

We broadly support ESMA’s proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_229>

**Q230: Do you agree with the proposed minimum threshold level for the open interest criteria for the publication of reports? If not, please state your preferred alternative for the definition of this threshold and explain the reasons why this would be more appropriate.**

<ESMA\_QUESTION\_230>

#### AFME Response



We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_230>

**Q231: Do you agree with the proposed timeframes for publication once activity on a trading venue either reaches or no longer reaches the two thresholds?**

<ESMA\_QUESTION\_231>

#### AFME Response

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_231>

### **7.3. Position management powers of ESMA**

**Q232: Do you agree that the listed factors and criteria allow ESMA to determine the existence of a threat to the stability of the (whole or part of the) financial system in the EU?**

<ESMA\_QUESTION\_232>

#### AFME Response

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

<ESMA\_QUESTION\_232>

**Q233: What other factors and criteria should be taken into account?**

<ESMA\_QUESTION\_233>

#### AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_233>

**Q234: Do you agree with ESMA’s definition of a market fulfilling its economic function?**

<ESMA\_QUESTION\_234>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_234>

**Q235: Do you agree that the listed factors and criteria allow ESMA to adequately determine the existence of a threat to the orderly functioning and integrity of financial markets or commodity derivative market so as to justify position management intervention by ESMA?**

<ESMA\_QUESTION\_235>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_235>

**Q236: What other factors and criteria should be taken into account?**

<ESMA\_QUESTION\_236>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_236>

**Q237: Do you consider that the above factors sufficiently take account of “the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives”? If not, what further factors would you propose?**

<ESMA\_QUESTION\_237>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_237>

**Q238: Do you agree that the listed factors and criteria allow ESMA to determine the appropriate reduction of a position or exposure entered into via a derivative?**

<ESMA\_QUESTION\_238>

AFME Response

We broadly support ESMA’s proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

<ESMA\_QUESTION\_238>

**Q239: What other factors and criteria should be taken into account?**

<ESMA\_QUESTION\_239>

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_239>

**Q240: Do you agree that some factors are more important than others in determining what an “appropriate reduction of a position” is within a given market? If yes, which are the most important factors for ESMA to consider?**

<ESMA\_QUESTION\_240>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_240>

**Q241: Do you agree that the listed factors and criteria allow ESMA to adequately determine the situations where a risk of regulatory arbitrage could arise from the exercise of position management powers by ESMA?**

<ESMA\_QUESTION\_241>

AFME Response

We broadly support ESMA’s proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.



Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

<ESMA\_QUESTION\_241>

**Q242: What other criteria and factors should be taken into account?**

<ESMA\_QUESTION\_242>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_242>

**Q243: If regulatory arbitrage may arise from inconsistent approaches to interrelated markets, what is the best way of identifying such links and correlations?**

<ESMA\_QUESTION\_243>

AFME Response

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

<ESMA\_QUESTION\_243>

## 8. Portfolio compression

### **Q244: What are your views on the proposed approach for legal documentation and portfolio compression criteria?**

<ESMA\_QUESTION\_244>

#### AFME Response

#### **FOREIGN EXCHANGE**

For FX, the GFXD understands that the FX market does not currently leverage compression services during the normal course of business. Whilst this may change during the future development of the markets and concurrent establishment of regulatory obligations, the global nature of the FX business, the short dated nature of the FX products and the high volume of market participants/transaction executed means that there are many operational challenges that will need to be addressed to ensure that the smooth running of the market, including the wide spread use of CLS in the settlement process do not become disrupted.

#### Methods of portfolio compression

Today there are robust solutions for multilateral compression operating in the market outside of the FX asset class. In this regard, generally speaking the criteria for compression outlined in the consultation paper are in line with the services offered by compression service providers today in the other derivative asset classes. However, we would note that as compression services have evolved it has become apparent that certain steps in the process are not necessarily required for all compression cycles. For example it is not always necessary to have a dress rehearsal, particularly in bilateral or unilateral compression cycles where the risk parameters are set.

Compression is not a price forming event and therefore, we request that the technical advice ESMA provides to the commission is not overly prescriptive. Rather we would suggest that the advice should set out a high level framework which provides participants with sufficient flexibility. Furthermore, it is important that counterparties retain control over their own risk profiles. Having prescriptive methodology and rules may not work for all counterparties and we would note that it is important that post trade risk reductions services should not be subject to other regulatory requirements that are designed for price forming transactions.

There is currently no standard industry process for bilateral compression direct between two parties, although we do acknowledge that compression services providers may, in the future, intend to support compression exercises between just two participants. While we suggest that the criteria and steps for direct bilateral compression activity should be aligned with those for multilateral compressions in existence in Credit and Rates adjusted as necessary to reflect the absence of a compression service provider, it should be recognised that bilateral compression exercises will often involve bespoke manual processes which are negotiated and established between the parties. Therefore, we would recommend that ESMA advises the Commission that any requirements should be sufficiently high level and should not undermine parties' ability to enter into bespoke arrangements.

Finally, we note that unilateral compression may also be offered in the future. This allows counterparties to reduce notional values on their books against a CCP. It is important that ESMA advises the Commission of the existence of such unilateral compression methods and advises the Commissions to include it as a suitable form of portfolio compression.



### Legal Documentation

We agree that it is imperative that relevant legal documentation should be in place between the parties to a compression exercise and that such documentation should adequately cover the activities such as reduction, termination and replacement of derivative transactions as will be caused by the compression process. In our view it is not necessary that the form of that documentation should be prescribed in the rules rather that firms participating in any form of compression exercise should satisfy themselves that the documentation in place is suitable for its purpose. We would also note that while compression can result in some derivative transactions being reduced and terminated or terminated and replaced, compression can also (i) result in fewer transactions, without any reduction in notional amounts (e.g. in the case of a compression recouping exercise) or (ii) involve the addition of new trades with the effect of the risk, notional and/or number of trades is/are reduced overall.

### Criteria and process steps:

As noted above we would suggest that any post trade compression service, be it multilateral, bilateral or unilateral, should comply with a set of framework criteria enshrined in legislation. We would suggest the following criteria:

1. the exercise is designed to be overall market risk neutral for each participant;
2. the participants of the exercise do not submit bids and offers to enter into a specific position;
3. the exercise is cycle-based and must be accepted in full by all participants or it will not be executed;
4. the exercise is designed to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk and operational risk.

In terms of process steps we would suggest the following high level description:

1. identifying participants for the relevant compression exercise;
2. derivative transactions submission – directly by participants or indirectly via a third party such as a clearing house;
3. proven methodology for identifying transactions eligible for compression, e.g. transaction linking;
4. compression proposal generation; and
5. compression execution.

As discussed above, we do not believe more prescriptive requirements as described in paragraphs 8 to 16 of Section 8.6 of the Discussion Paper are required.

<ESMA\_QUESTION\_244>

**Q245: What are your views on the approach proposed by ESMA with regard to information to be published by the compression service provider related to the volume of transactions and the timing when they were concluded?**

<ESMA\_QUESTION\_245>

AFME Response

**FOREIGN EXCHANGE**

For FX, the GFXD understands that the FX market does not currently leverage compressions services during the normal course of business. Whilst this may change during the future development of the markets and concurrent establishment of regulatory obligations, the global nature of the FX business, the short dated nature of the FX products and the high volume of market participants/transaction executed means that there are many operational challenges that will need to be addressed to ensure that the smooth running of the market, including the wide spread use of CLS in the settlement process do not become disrupted.

As explained above, compressions (in which ever form) are not a price forming events. As such, we question the value of reporting such information although we note that at an aggregate level, such published information (combined with other metrics of turnover) may convey information to market participants. Regardless of the objective, it is important to note that the approach for publishing information related to a compression exercise needs to recognise differences between multilateral, bilateral and unilateral processes. The primary concern of our members is that any information published should not disclose identities of firms and any actual positions. We are aware that on occasion there may only be one firm from a particular participant category participating in a multi-lateral compression exercise and therefore we would suggest that reporting by participant type should not be required by the regulation. Similarly, by their nature, direct bilateral compression exercises could disclose information that is attributable to a participating firm. We would therefore caution against requirements to publish this information for these types of compression processes until further consideration has been given to how this can be achieved without unduly disclosing sensitive information.

Regarding the actual information that needs to be reported we suggest that the critical information relates to the notional amount of transactions compressed. We therefore suggest that the information published is restricted to i) the notional amount of transactions submitted (and accepted) to be part of the compression exercise, and ii) the notional amount of transactions terminated as a result of the exercise. This information should include all transactions in the compression cycle irrespective of whether the participant is in scope for EMIR and be published at an aggregated market level by product type and currency for each compression cycle. In the case of product type we suggest that this should be interpreted as per asset class only. In our view, a more granular designation will be more challenging to implement and provide limited added value. To the extent that ESMA is inclined to advise the Commission to adopt a more granular approach, for the interests of certainty and avoidance of confusion, such granular approach should be consistent with the ISDA taxonomy.

In the context of APA reporting and the time at which transactions subject to portfolio compression were concluded we suggest that this should be the time at which the compression service provider communicates to all participants that the compression exercise proposal has become legally binding. However, it should be noted that the compression exercise can have taken legal effect at another point in time in accordance with the compression contract between the compression participants.

#### As close to real time as possible

As explained above there are differences between bilateral, multilateral and unilateral compression techniques and the infrastructure around the compressions exercises. Such differences involve timing constraints.

In respect of multilateral or unilateral compression services and provided the safeguards in relation to sensitive information we have proposed above are adopted, in our view information can be reported almost immediately.

By contrast, there is currently no developed infrastructure for bilateral compression services and they rely on bespoke arrangements. In our view it will not be possible for bilateral services to



report within the same time frame as multilateral and/or unilateral services. To ensure consistency and avoid duplicative requirements, we would therefore recommend that ESMA advise the Commission that, in the context of bilateral compression services, the reporting deadlines should align with the reporting requirements under EMIR (i.e. by close of business on the day following the conclusion of the compression exercise).

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