AFME Response to the ESMA Consultation Paper on the functioning of the Organised Trading Facility (OTF) regime in the European Union

November 2020

Executive Summary

AFME welcomes the opportunity to respond to the ESMA Consultation Paper on the functioning of the Organised Trading Facility (OTF) regime in the European Union. The functioning of the OTF regime is an important and impactful topic in and of itself.

However, AFME notes that the paper goes on to examine elements such as multilaterality; so called "*networks of systematic internalisers*"; software and matched principal trading. These are all concepts which are central to the MiFID regime and which have significant impacts outside of the OTF construct. If read across the entire MiFID II/MiFIR regime, such changes could have negative consequences for liquidity, market functioning and ultimately for end users of European financial markets. This is because ESMA's interpretation of "*multilateral systems*", as expressed in paragraph 43 of the consultation paper, could capture not only all bilateral trading but also a multitude of communication platforms, information aggregators, distributors of data and connectivity utilities (including EMS, OMS, instant messaging services or even email applications). We do not believe that this is the intention of the legislator. This would fundamentally reduce the ability of buyers and sellers of securities to bilaterally identify and subsequently execute trades with one another in ways that improve outcomes for market participants and end investors.

AFME considers that a diverse set of open and competitive execution venues and methodologies for securities trading help different end users achieve their individual mix of execution objectives in the most efficient and bespoke manner possible. Efficient and liquid financial markets in turn allow issuers to raise capital at attractive prices and support the efficient allocation of capital by investors. A robust and diversified market structure also fosters financial stability by providing a reliable cushion during distressed market conditions.

Investors need low transaction costs, choice and flexibility in order to achieve best execution. Exchanges and MTFs provide greater immediacy for smaller orders, however, there is over an 80% chance of price movement immediately after execution for mid and large size orders, adding to the implicit cost of trading for pensioners and savers. If investors prioritise efficiency, lower price impact and lower overall transaction costs, they need to have the option of accessing alternative execution venues which can provide a safeguarded environment when trading, avoiding certain opportunistic trading strategies and limiting the market impact of trading decisions.

Any proposals that would have the effect of changing the law regarding elements such as multilaterality; the use of software and other systems that support bilateral trading and matched principal trading could have significant impacts outside of the OTF regime if read across the entire MiFID II/MiFIR framework including reducing the healthy competition and beneficial diversity of financial markets as described previously. This is unnecessary, unwarranted and risky. The lack of proper examination of the potential impacts to non-OTF trading means significant unidentified downside risks may exist. AFME does not consider that significant changes need to be implemented to the OTF regime, or to other aspects examined in this paper, and that the relevant definitions are already clear. Therefore, AFME members stress that a conservative, proportionate

and balanced course of action should be adopted to further legislative change. Other avenues are available to regulators to enhance consistent application of the existing rules.

The industry has adapted to the MiFID regime since its go live in 2018 and continues to adapt. However, a steady state has not yet emerged and thus any alterations to the regime especially based on a mix of EU28 and EU27 data, are premature and would be directed at an evolving market structure and unlikely to be effective.

Any Level 1 changes to core concepts in the regime could have far reaching implications and AFME would counsel for a period of consistent application and appropriate enforcement preceding any consideration of further legislative change.

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

AFME members highlight the absence of UK OTFs from some of the statistical analysis outlined in figures 1 through 12 on pages 9 through 19 of the consultation paper. Members question the validity of those findings which exclude UK data.

OTFs are a new concept in terms of trading non-equity financial instruments, introduced under MiFIR/MiFID II in 2018 to capture within scope of the transparency regime a specific part of the market, namely, Inter-dealer brokers (IDBs). AFME members engagement with OTFs has remained consistent throughout this transitional period from IDB to OTF. As end-users of OTFs, AFME members have not experienced any disruption to the functioning of the market caused by the reclassification process.

Members agree with ESMA's findings outlined in paragraphs 17 to 19, illustrating that the average transaction size traded on OTFs is significantly larger compared to the size of trades conducted on regulated markets or MTFs. However, overall, the total trading activity of bonds on OTFs remains low compared to total trading activity of bonds via other trading systems. This is because typically OTFs are the home for conducting large legacy trades and trades in exotic or emerging market bonds which are often illiquid and trade relatively infrequently.

Members commend the operators of OTFs efforts to comply with the transparency requirements set out in MiFIR/MiFID II. However, operationally members request that OTFs invoice/billing procedures be standardised. Currently, the way in which OTFs provide this information varies significantly between firms, with different OTFs applying different standards. This make it extremely difficult and laborious for clients of OTFs to reconcile their accounts.

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

Members question how these findings have been captured and suggest that perhaps figure 4 (page 11) only considers trading activity where the broker acts as the principal of the trade. Within cash bond trading the OTF often 'sits in the middle' of the bank-to-bank trades, with the fee embedded in the price.

Members reiterate that OTFs were introduced under MiFIR/MiFID II to cater for a very specific section of the trading system that was not previously captured under MiFID I. Members stress that non-equity products traded on OTFs are the same financial instruments traded previously by inter-dealer brokers prior to the establishment of OTFs and by the same counterparties.

In terms of the EU landscape, AFME members do not anticipate the emergence of any further OTFs. In retrospect, AFME members note the harmonisation and consolidation of operators of interdealer brokers and, subsequently, OTFs over the last decade. This could be considered a challenge for new entrants into the market.

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

No, AFME does not think that is necessary or indeed advisable to amend Level 1 as suggested.

The restriction within Article 1(7)[1] and the definition of multilateral system under Article 4(1)(19)[2] of MiFID II, particularly when taken in conjunction with general guidance provided by ESMA through Q&As (in particular Q&A 7 and 10 of the section of Q&As on MiFID II and MiFIR market structures topics, ref. ESMA70-872942901-383), are clear and fit for purpose.

Therefore, the focus should be on consistent application across the Union and, if necessary, enforcement. Further legislative change should be considered only if, after a period of consistent application and appropriate enforcement, there continue to be issues.

ESMA's interpretation of "*multilateral systems*", as expressed in paragraph 43 of the consultation paper, could capture not only all bilateral trading but also a multitude of communication platforms, information aggregators, distributors of data and connectivity utilities (including EMS, OMS, instant messaging services or even email applications). We do not believe that this is the intention of the legislator. This would fundamentally reduce the ability of buyers and sellers of securities to bilaterally identify and subsequently execute trades with one another in ways that improve outcomes for market participants and end investors.

The text in paragraph 43 goes beyond the existing Article 4(19) of MiFID II which defines a multilateral system as:

*"…any system or facility in which **multiple third-party** buying and selling trading interests in financial instruments are able to interact in the system*".

Any incorporation of the text in paragraph 43 should be amended as follows:

"*ESMA considers that any system that allows **multiple third-party** trading interests in financial instruments to interact, including information exchange between parties on essential terms of a transaction (being price, quantity) with a view to dealing in those financial instruments is sufficient to require authorisation as a trading venue*".

[1] Article 1(7) of MiFID II: "All multilateral systems in financial instruments shall operate either in accordance with the provisions of Title II concerning MTFs or OTFs or the provisions of Title III concerning regulated markets. (…)".
[2] Article 4(19) of MiFID II: a multilateral system "means any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system".
[3] ESMA Questions and Answers on MiFID II and MiFIR market structures topics, Section 5.2 Organised Trading Facilities (OTF).

AFME considers that a diverse set of open and competitive execution venues and methodologies for securities trading help different end users achieve their individual mix of execution objectives in the most efficient and bespoke manner possible. Efficient and liquid financial markets in turn allow issuers to raise capital at attractive prices and support the efficient allocation of capital by investors. A robust and diversified market structure also fosters financial stability by providing a reliable cushion during distressed market conditions.

Any proposals that would have the effect of changing the law regarding elements such as multilaterality; the use of software and other systems that support bilateral trading and matched principal trading could have significant impacts outside of the OTF regime if read across the entire MiFID II/MiFIR framework including reducing the healthy competition and beneficial diversity of financial markets as described previously. This is unnecessary, unwarranted and risky. The lack of proper examination of the potential impacts to non-OTF trading means significant unidentified downside risks may exist. AFME does not consider that significant changes need to be implemented to the OTF regime, or to other aspects examined in this paper, and that the relevant definitions are already clear. Therefore, AFME members stress that a conservative, proportionate and balanced course of action should be adopted to further legislative change. Other avenues are available to regulators to enhance consistent application of the existing rules.

The industry has adapted to the MiFID regime since its go live in 2018 and continues to adapt. However, a steady state has not yet emerged and thus any alterations to the regime especially based on a mix of EU28 and EU27 data, are premature and would be directed at an evolving market structure and unlikely to be effective.

Compelling software providers to become authorised as trading venues under MiFID II and subjecting them to complex and costly regulatory requirements will prevent these platforms from continuing to exist in their current form; limit their ability to continue to grow and develop; and ultimately reverse and stifle healthy competition and diversity within the marketplace. Such a stringent measure, as proposed by ESMA, will therefore limit competition in the market and reduce market efficiency with the costs being borne by the end user.

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

As per the answer to Question 3 (above) AFME does not support ESMA's two-step approach because, the relevant definitions are already clear and, we remain concerned that ESMA's interpretation is excessively restrictive and could lead to unintended consequences for the reasons given in our response. AFME members suggest that ESMA's action in this field should shift to supporting convergent supervision and, if necessary, enforcement.

Fostering more convergent supervision in this arena would level the playing field across Europe while allowing NCAs to exploit their closer understanding of the operation of local markets in their jurisdictions to bring about the results which the legislator intended.

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

AFME agrees with ESMA's position in paragraph 53, not to amend the current OTF authorisation regime. Nevertheless, over the last decade AFME members have witnessed the consolidation of OTFs (formerly interdealer brokers). From a user's perspective this has vastly reduced competition and led to increased transactional and data costs, ultimately to the disadvantage of the end investor. With this in mind, AFME members suggest that, should ESMA decide to implement any future amendments to the regime, a proportional approach should be taken in order to enhance competition, increase innovation, diversity, and resilience.

Q6: Which provisions applicable to OTFs are particularly burdensome to apply for less sophisticated firms? Which Level 1 or Level 2 amendments would alleviate this regulatory burden without jeopardising the level playing field between OTFs and the convergent application of MiFID II/MiFIR rules in the EU?
[AFME is not responding to this question]

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

AFME members believe the current definitions around OTF, multilateral systems, reception and transmission of orders and execution are clearly understood by the market and no further complexities should be introduced now. AFME members recognise the clear distinction between multilateral systems including OTFs and the bilateral nature of RTO investment services.

AFME believes the text is clear that multilateral systems exclude bilateral systems where an investment firm enters into every trade on own account, as explained in Recital 7 MiFIR[4].

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

We are not aware of networks of systematic internalisers that operate as a multilateral system. As ESMA acknowledges in paragraph 32, "*the information received in this respect comes primarily from authorised trading venues…*".

Paragraph 57 of the ESMA paper makes three assertions, which we address in turn:

1. "*First, some market participants noted that the distinction between bilateral trading and multilateral trading is being blurred due the setting up of networks of SIs, and invited ESMA to further look into this issue."*

We suggest this charge is made by those authorised trading venues motivated to seek further amendments or clarifications in the legislation in order to drive trading onto their platforms and away from legitimately trading systematic internalisers, thus putting their commercial interests ahead of bringing efficiencies to the market in the way that is offered by a choice of complementary and competitive execution venues.

[4] Recital 7 MiFIR "The definitions of regulated market and multilateral trading facility (MTF) should be clarified and remain closely aligned with each other to reflect the fact that they represent effectively the same organised trading functionality. The definitions should exclude bilateral systems where an investment firm enters into every trade on own account, even as a riskless counterparty interposed between the buyer and seller. Regulated markets and MTFs should not be allowed to execute client orders against proprietary capital (…)".

2. "*Second, they stressed that some SIs do not comply with the prohibition, when dealing on their own account, from entering into matching arrangements with entities outside their group to carry out de facto riskless back-to-back transactions through arrangements with third party liquidity providers."*

In AFME members' experience, systematic internalisers interact with each other legitimately. For example:

Scenario A - Handling client orders

When acting for clients, the investor protection rules create a clear expectation that they should consider other systematic internalisers when constructing their execution policies. Investment firms offer execution services which sometimes include them acting in an SI capacity. In most instances AFME firms will be working on an order handling basis and will discharge their best execution responsibilities through accessing a variety of execution venues and also other firms or systematic internalisers. For this reason, it is likely that some member firms will consider other systematic internalisers as one of the options that are available when looking for the best execution outcomes for their clients. AFME members do not believe that the establishment of any such relationships compromises the requirement under Recital 19 of the Commission Delegated Regulation (EU) 2017/565[5] that bilateral systems should not undertake matched principal transactions on a regular basis. This is because even in this construct each investment firm will be acting on behalf of a client when facing the other SI and in all cases trading on a one-to-one bilateral basis with that systematic internaliser.

Scenario B - Own account risk management

Investment firms will manage risk by trading on venue, predominately, and also trade bilaterally with others, including systematic internalisers, for the benefit of end clients. In such circumstance both parties would be dealing on own account.

The existing MiFID II/MiFIR regime supplemented with ESMA guidance on back to back transactions (Q26 of ESMA's market structures topics Q&A (ref. ESMA70-872942901-38[6])), is clear, well understood and fit for purpose. AFME would suggest that given the clarity of the existing regime, if concerns exist with individual participants the existing rules should be enforced rather than pursuing further legislative change.

3. "*Third, trading venues claimed that Broker Crossing Network (BCN) trading volumes under MiFID I have shifted to SIs instead of moving to multilateral trading venues. In their view, this demonstrates the failure of MiFID II to move more trading to lit venues."*

In our response to the ESMA CP on Equities Transparency earlier this year and in our Liquidity Landscape paper[7], AFME has already raised concerns about the representation of the volumes traded on trading venues and systematic internalisers. Financial markets regulatory policy should be data-driven and be based on evidence provided by thorough data analysis. The relatively low volume of bilateral and risk-intermediated trading activity on systematic internalisers is not substitutable by other non-intermediated trading. Execution venue choice is driven by investors' different investment objectives and strategies and since investors needs have remained consistent over time then the stability of lit venues volumes is unsurprising. Historic representations of BCN activity by the authorised trading venue community was always

[5] "Pursuant to Directive 2014/65/EU, a systematic internaliser should not be allowed to bring together third party buying and selling interests in functionally the same way as a trading venue. A systematic internaliser should not consist of an internal matching system which executes client orders on a multilateral basis, an activity which requires authorisation as a multilateral trading facility (MTF). An internal matching system in this context is a system for matching client orders which results in the investment firm undertaking matched principal transactions on a regular and not occasional basis."

[6] https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf ESMA Questions and Answers on MiFID II and MiFIR market structures topics, Section 5.2 Organised Trading Facilities (OTF).

[7] Understanding the Liquidity Landscape in European Equity Markets https://www.afme.eu/reports/publications/detail/Understanding-the-Liquidity-Landscape-in-European-Equity-Markets

exaggerated and cannot now be claimed to have transferred to systematic internalisers. Volumes reported as systematic internaliser remain a mix of bilateral trading and non-addressable technical trades.

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

Yes, the line differentiating bilateral and multilateral trading in the context of systematic internalisers is clear.

No, there should not be a Level 1 amendment with the potential to add complexity to the regime
The existing regime is clear, fit for purpose and well understood as per our answer to Q8 above. AFME suggests that if concerns exist with individual participants the existing rules should be enforced rather than pursuing further legislative change.

As per our answers to the Questions above, AFME members support diversity in financial markets and utilise a variety of platforms to provide and access liquidity for the benefit of their end clients' best execution outcomes. Technological advances and healthy competition in market structure has delivered improved outcomes the users of and participants in European capital markets. AFME members support the existing legislative approach and stress the value of systematic internalisers, in particular, adding to the diversity and liquidity of European capital markets.

Any technological advances and market structure diversity that supports systematic internalisers' contribution to markets (in terms of liquidity, efficiency and best execution outcomes) within the current regime should be protected and retained. At the same time, AFME notes and agrees with ESMA that the obligation under Article 1(7) of MiFID II and the definition of a multilateral system under Article 4(19), taken in conjunction with the aforementioned ESMA Q&A, has the effect of recognising that any qualifying multilateral system must request authorisation as a trading venue.

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

As stated in Question 3, AFME members are concerned that ESMA's proposed interpretation of what qualifies as a "*multilateral system"*, and therefore its expectations of what might need to be regulated as a multilateral venue, is too broad. The software provider concept encompasses a multitude of different types of providers and business models. AFME members note that under the current regime provisions are made for the operation of diverse software and communications platforms such as EMS, OMS, chat, voice, RFQ, bulletin boards and so on which are not acting in a multilateral fashion in accordance with the regime. AFME members support healthy competition and diversity in financial markets and utilise a variety of platforms/utilities to provide and access liquidity for the benefit of their end clients. Technological advances and market structure innovation has delivered improved outcomes the users of and participants in European capital markets.

Characteristics of software providers
A key characteristic of the definition of multilateral is that of many to many interaction. In non-equity markets in particular, the interaction in software is on a bilateral basis, as in any EMS or OMS, which routes trades bilaterally. Aggregation of bilateral indications (with no multilateral interaction) is still communication on a bilateral basis and thus does not require authorisation as a multilateral facility.

It should be the design of the system, the role the software provider assumes, their involvement and responsibilities in the day-to-day operation, the type of protocols and interactions between participants within them that should be evaluated rather than superficial similarities with incumbent/legacy trading venues.

We also believe that it is important to distinguish between (i) systems that allow multiple third parties to interact in a system, and (ii) systems that allow for multiple bilateral interactions with existing relationships (where each bilateral interaction cannot interact with each other). The former are true multilateral systems while the latter are a collection of bilateral relationships with no multilateral aspects.

In addition, any facility where there is no genuine trade execution taking place in the system (see MiFIR Recital 8) and which does not have any involvement on how and where the trade might take place, should not be forced to become a trading venue. As ESMA stated in its Q&A on market structure topics (Question 7), "*the fundamental characteristic of a trading venue is to execute transactions*".

We therefore believe that, ultimately, this should be a matter of supervision and enforcement rather than further legislative change. National regulators should engage with these technology providers and ensure they have the correct permissions in place.

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

No, AFME disagrees that a service provider should need to be authorised as an MTF or an OTF if execution happens elsewhere. To introduce such a requirement would not level the playing field with venues, but, on the contrary, would significantly tilt it in favour of larger, existing venues that are already set up to comply with the requirements, to the disadvantage of service providers that might in future in some cases become their competitors but that, as things stand, provide quite a different service that supports bilateral negotiations ahead of a trade being formalised on a venue.

Negotiated trades are critically important, in particular, for the non-equities markets. Negotiated trades are utilised by firms that wish to negotiate orders (often utilising voice) bilaterally for best execution attainment purposes and to minimise information leakage resulting in better outcomes for end clients than other trading methods (such as RFQs, OTFs or regulated markets). Negotiated trades are a particularly relevant trading method for less liquid, less frequently traded instruments and/or large in scale (LIS) trades. Negotiated trades meet the transparency objectives in MiFID II/MiFIR but that transparency reporting requirement can introduce a necessary reporting system/workflow overhead for firms.

In certain instances, counterparties want to manage more effectively counterparty risks by submitting transactions to venues for the purposes of CCP clearing. A negotiated trade that is pre-arranged between two counterparties bilaterally then moved onto a venue to be executed under the rules of that venue of exchange is also known as a process trade. The process trade has the advantages of the negotiated trade allowing for the benefits of bilateral price discovery (described above) coupled with the additional on venue advantages of integrated transparency reporting, settlement and enabling STP (straight through processing) flow. The execution clarity provided by an on venue print can also be a valuable benefit to institutional investors for the purposes of meeting governance protocols.

A variety of software providers and their proprietary software systems have emerged to support negotiated trades and enable the increasing sophistication and automation of the STP nature of process trades. These emergent technologies have introduced efficiencies and improved outcomes for users and end clients. AFME members note that under the current regime provisions are made for their operation and the focus should be on ensuring supervisory convergence rather than further legislative change.

The growth and visibility of negotiated trades on venue is a demonstrable example of regulation as an enabler to venues' innovation to drive efficiencies for the market more broadly, serving the needs of market participants and ultimately delivering benefits to the end investor within the legal perimeter of the regime. Such negotiated trades provide market liquidity, are transparent and provide a blend of service that is desirable to the bespoke requirement of an important segment of clients.

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

Yes, we agree that any system that merely receives, pools, aggregates and broadcasts indications of interest, bids and offers or prices should not be considered a multilateral system. That means that a bulletin board should not be considered a multilateral system. This is because there is no reaction of one trading interest to another other within these types of facilities.

The link between a bulletin board and the client is typically electronic. The bulletin board electronically links together broadcast buying and selling indications. The electronic link should not allow communication or negotiation or notification of any potential matches. Any electronic bulletin board should not allow execution.

AFME considers displaying contact details in an electronic bulletin board a security risk and should not be allowed. The indication of interest 'owner' can be identified without displaying telephone numbers or email addresses.

AFME supports a definition of bulletin board that follows the approach described in paragraph 80 in the consultation paper.

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

No, our members are not aware of any facility operating a bulletin board that does not comply with the principles identified. Bulletin boards, as stated in MiFIR recital 8, are out of scope and should not be considered as trading venues.

Furthermore, we would suggest that given the clarity of the existing regime, if concerns exist with individual participants the existing rules should be enforced rather than pursuing further legislative change.

Q14: Market participants that currently operate such systems are invited to share more detailed information on their crossing systems (scale of the activity, geographical coverage, instruments concerned, etc...), providing examples of such platforms and describing how much costs & fees are saved this way as opposed to executing the relevant transactions via brokers or trading venues.
[AFME is not responding to this question]

Q15: Do you consider that internal crossing systems allowing different fund managers within the same group to transact between themselves should be in scope of MiFID II or regarded as an investment management function covered under the AIFMD and UCITS? Please explain. In your view, should the regulatory treatment of these internal crossing system be clarified via a Level 1 change?
[AFME is not responding to this question]

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

AFME members consider the concept of discretion to be clear and the following terms "*exercise of discretion*" and "*execution on a discretionary basis*" to be satisfactorily outlined in the relevant ESMA Q&As.

Furthermore, we agree and are satisifed with ESMA's interpretation that the application of discretion varies depending on the type of trading system operated by the OTF as outlined in paragraphs 103 through 105 (page 35) of the consultation paper.

Q17: For OTF operators: Do you apply discretion predominantly in placement of orders or in execution of orders? Does this depend on the type of trading system you operate? Please explain.
[AFME is not responding to this question]

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

To date, AFME members have not experienced any issues with the way OTF operators exercise discretion for order placement and order execution.

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

AFME agrees that it is not necessary to undertake any specific review or recommend any specific measure regarding the use of MPT (matched principle trading).

AFME members believe the current definitions are clearly understood by the market and no further complexities should be introduced. We would suggest that given the clarity of the existing regime, if concerns exist with individual participants the existing rules should be enforced rather than pursuing further legislative change.

AFME considers that a diverse set of open and competitive execution venues and methodologies for securities trading help different end users achieve their individual mix of execution objectives in the most efficient and bespoke manner possible. Efficient and liquid financial markets in turn allow issuers to raise capital at attractive prices and support the efficient allocation of capital by investors. A robust and diversified market structure also fosters financial stability by providing a reliable cushion during distressed market conditions.

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movement immediately after execution for mid and large size orders, adding to the implicit cost of trading for pensioners and savers. If investors prioritise efficiency, lower price impact and lower overall transaction costs, they need to have the option of accessing alternative execution venues which can provide a safeguarded environment when trading, avoiding certain opportunistic trading strategies and limiting the market impact of trading decisions.

Any proposals that would have the effect of changing the law regarding fundamental concepts such as matched principal trading could have significant impacts outside of the OTF regime if read across the entire MiFID II/MiFIR framework including reducing the healthy competition and beneficial diversity of financial markets as described previously. This is unnecessary, unwarranted and risky. The lack of proper examination of the potential impacts to non-OTF trading means significant unidentified downside risks may exist. AFME does not consider that significant changes need to be implemented to the OTF regime, or to other aspects examined in this paper, and that the relevant definitions are already clear. Therefore, AFME members stress that a conservative, proportionate and balanced course of action should be adopted to further legislative change. Other avenues are available to regulators to enhance consistent application of the existing rules.

The industry has adapted to the MiFID regime since its go live in 2018 and continues to adapt. However, a steady state has not yet emerged and thus any alterations to the regime especially based on a mix of EU28 and EU27 data, are premature and would be directed at an evolving market structure and unlikely to be effective.

Any Level 1 changes to core concepts in the regime could have far reaching implications and AFME would counsel for a period of consistent application and appropriate enforcement preceding any consideration of further legislative change.

Q20: In your view what is the difference between MPT and riskless principal trading and should this difference be clarified in Level 1? In addition, what, in your view, incentivizes a firm to engage in MPT rather than in agency cross trades (i.e. trades where a broker arranges transactions between two of its clients but without interposing itself)?

AFME members believe the current definitions are clearly understood by the market and no further complexities should be introduced. Rather, we would suggest that given the clarity of the existing regime that the priority should shift to enforcement rather than incremental legislation.

As per our answer to Question 19, AFME agrees that is not necessary to undertake any specific review or recommend any specific measure regarding the use of MPT.

In an equities context, RPT (riskless principal trading) and MPT share similar characteristics: A client places an order with the firm and the firm executes the order against whatever sources can provide the most effective execution for the client. Most institutional orders are executed against a variety of venues and sources of liquidity in many individual sub-trades. The investment firm incurs no market risk. The client settles with the investment firm as principal providing the client with a single point of settlement and a known credit risk regardless of the number of venues used by the broker. This reduces the costs, risks and complexity of settlement whilst allowing access to all available liquidity and the selection of the best execution prices.

In RPT, the average price of the many individual executions is calculated and passed back to the client with only a commission added for the service, whereas in MPT, each individual execution is communicated back to client.

Clients demand this service where it is their preference to face a known counterparty with a known risk profile.

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

AFME notes that ESMA is of the view that a divergent interpretation of the provisions specified in this section of the consultation paper could potentially result in an unlevel playing field in the EU.

AFME does not think it is necessary to clarify the existing regime but has no strong objection to a clarification in Level 1 or otherwise that that the restriction on dealing on own account in Article 19(5) of MiFID II should be interpreted as applying only to the MTF operated by the investment firm and not that an investment firm operating an MTF could not act in a principal capacity because the point is already clearly inferred by the existing text and therefore does not necessitate further legislative change.

AFME is of the opinion that any diverging interpretations that might contribute to the creation of an unlevel playing field in the EU should first be addressed through improved supervisory convergence measures.

AFME asserts the important role of OTC trading by market participants, liquidity providers and systematic internalisers in ensuring capital markets remain liquid, diverse and competitive for the benefit of end clients and the European economy. It is important that firms that operate MTFs are also able to continue dealing as principal as this provision of capital adds to capital formation and improves liquidity for the benefit of the European financial markets for the benefit of users and end clients. The provision of principal capital serves to improve overall market liquidity in secondary markets and, potentially, lowers costs of financing in primary markets. This is a particularly critical role to be played for less liquid, less frequently traded instruments and/or large in scale (LIS) trades. A direct relationship plays an important value-additive function for specific trade types and for specific instrument characteristic types. Thus, fostering direct relationships in capital markets is very important for the good functioning of the market for the benefit of the end clients and the European economy.

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AFME contacts

Julian Allen-Ellis, Director, MiFID
Julian.Allen-Ellis@afme.eu

Olu Oluwole, Manager, MiFID and Equity Capital Markets
Olu.Oluwole@afme.eu

Pedro Pinto, Director, Advocacy
Pedro.Pinto@afme.eu

About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.