esma European Securities and Markets Authority

Reply form for the Consultation Paper on MiFID II/ MiFIR review on the functioning of Organised Trading Facilities (OTF)

25 September 2020 | ESMA70-156-3844

Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **25/11/2020.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_FOTF_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_FOTF_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_FOTF_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on the functioning of the Organised Trading Facility regime").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response 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 under the heading Legal Notice.

Who should read this paper

This document will be of interest to (i) alternative investment fund managers, UCITS management companies, EUSEF managers and/or EuVECA managers and their trade associations, (ii) distributors of UCITS, alternative investment funds, EuSEFs and EuVECAs, as well as (iii) institutional and retail investors investing into UCITS, alternative investment funds, EuSEFs and/or EuVECAs and their associations..

General information about respondent

Name of the company / organisation	Finance Denmark
Activity	Investment Services
Are you representing an association?	☒
Country/Region	Denmark

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_FOTF_1>

Finance Denmark[1] welcomes the opportunity to respond to the ESMA consultation on the functioning of Organised Trading Facilities (OTF) with a deadline on 25 November 2020.

As the deadline for this consultation falls within the second wave of the COVID-19 pandemic, which continues to put significant restraints on the functioning of all stakeholders, we reserve the right to come back with further comments at a later stage. In particular we would like to underline the importance of taking a cautious approach to any legal changes at this point in time as the market situation as a consequence of COVID-19 is and will be for a long period of time, under significant stress and not fit for absorbing larger amendments. Moreover, if amendments are made it is crucial that the need for adequate implementation time is considered.

General comments

First of all, Finance Denmark is very concerned about the scope of the consultation which appears to be significantly broader than mandated in MiFIDII, art. 90(1)(a), and inter alia includes the definition of multilateral systems and defines systematic internalisers' trading capabilities which are relevant for all instruments and not only for non-equities.

Secondly, Finance Denmark finds that ESMA puts too little emphasis on the definition of "multilateral" in MiFIDII, art. 4(1)(19), where it is clearly stated that in order to be labelled as

1 Finance Denmark is a business association for banks, mortgage institutions, asset management, securities trading and investment funds in Denmark. EU Transparency Register – registration number 20705158207-35

multilateral, clients should be able to interact in the system. Therefore, a facility where clients cannot interact with each other is **not** multilateral and should not be deemed as such via requirement to seek authorization as a trading system.

Additionally, Finance Denmark does not agree with the emphasis on ESMA's own Q&As as legal references for the interpretation of "systematic". In case ESMA experiences SIs which do not act bilaterally, Finance Denmark suggests enhancing the description of the SI activity to eliminate any doubts of what proper SI activity is. This should be implemented on level 1 or 2 instead of Q&As as is the case today. Please see our concrete proposal in our response to Q9.

Thirdly, the conclusions and proposed steps will, if implemented, reintroduce a kind of concentration rule contrary to the purpose with MiFID I & II as ordinary brokerage activity would be de facto prohibited and SI activity would be complicated even further. Furthermore, there is a significant risk of compromising the well-functioning and transparent Danish covered bond market where trading is mainly covered via SIs. As the covered bond market work there is a need for SI/market makers, which put their own capital at risks and need the ability to manage such risk. SIs are often acting as a "buffer" (intermediary) ensuring that unequal and often large (opposite) order sizes can be facilitated efficiently when the SI uses its risk capital (e.g. when two clients want to trade in the same instrument, but in unequal sizes or all want either to sell or to buy at the same time). Complicating or even removing the possibility for SI trading will threaten the overall market liquidity and quality. Less efficient secondary markets will have negative implication on the primary markets with detrimental effects on the capital markets and therefore on the real economy.

The consequences are severe for clients as they will face considerably higher costs due to higher execution costs and increased market impact. This is not least due to low quality of the trading venues' order books as elaborated below. Competition within trading was introduced with MiFIDI in 2007 and expanded even further with MiFIDII/MiFIR in 2018 where the requirements for becoming an SI were formalized and OTFs were introduced. These changes were not at least introduced as an acknowledgement of client needs and the differences in the way various financial instruments are traded most efficiently and with minimal market impact.

For all clients there is a wish to minimize costs and maximize return. There is no reason in punishing investors by forcing them to accept higher costs due to fewer choices and lower execution quality. This is not proper investor protection as the different trading forms serve a purpose for clients and must be able to co-exist.

<ESMA_COMMENT_FOTF_1>

Questions

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

<ESMA_QUESTION_FOTF_1>

Finance Denmark is of the opinion that the OTF regime covers a gap in the capital markets with respect to non-equities and in particular bonds and derivatives which otherwise would have been covered mainly by OTC trading. At this moment in time, the OTF may not have gathered a significant market share, but in the opinion of Finance Denmark, this is merely a question of time. In order not to create further fragmentation in the equity space, MiFIDII/MiFIR rightly limit the scope to non-equity instruments. Hence, Finance Denmark strongly urges **not** to extend the current OTF regime to equities as liquidity will be fragmented even further since the OTFs will attract liquidity from the RMs and the MTFs. OTFs can do so by using the possibility to use discretion in the execution and to use the OTFs possibilities to determine access criteria.

<ESMA_QUESTION_FOTF_1>

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?

<ESMA_QUESTION_FOTF_2>

With a view to figure 7 on page 13, it is Finance Denmark's assessment that the incentive to use OTF for larger trades may be explained – at least partly – as a consequence of the OTF's possibility to use discretion in the execution, thereby providing a tool to minimize market impact. This possibility is particularly relevant for larger trades.

<ESMA_QUESTION_FOTF_2>

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?

<ESMA_QUESTION_FOTF_3>

First of all, Finance Denmark needs to direct the attention to provision 36 in the Consultation Paper and Q7, page 40 in ESMA's Q&A on Market Structure, as there seems to be a contradiction: Q7 says: *"Can a trading venue use its trading systems and platforms to arrange transactions that are then reported and ultimately executed on another trading venue? Answer 7 No, the fundamental characteristic of a trading venue is to execute transactions…*", whereas provision 36 in the consultation paper says the opposite: *" 36.*

Furthermore, the definition of multilateral systems does not require the conclusion of a contract as a condition but simply that trading interests can interact within the system. It results from such definition, read in conjunction with Article 1(7) of MiFID II, that the conclusion of a contract is not a prerequisite for an investment firm or a market operator to be required to request authorisation as a trading venue for the system it operates."

It is Finance Denmark's firm opinion that the present Q7 should continue to apply and we direct the attention to the emphasis on the requirements for clients to interact with each other.

Furthermore, reading provision 36 in conjunction with provision 38, where provision 38 states that a facility that does not comply with all aspects of the definitions of trading venues has to seek authorisation as such, the scope becomes even broader.

Adding the content of provisions 49 and 50, where a system is defined as techno-logy neutral and includes both automated as well as non-automated systems (provision 49) and there is no threshold below which the activity would be exempted from the authorisation (provision 50), the definition of a Multilateral System becomes too broad and too much activity will be deemed as multilateral. It would entail that ordinary, manual brokerage activity would require authorisation as an OTF (or other trading venue). This would be out of proportion.

With these comments in mind, Finance Denmark does not support the proposal of moving MiFIDII, art. 1(7) into MiFIR followed by a rephrasing of the wording formulating the current restriction as a prohibition. In our view, too many activities which are not multilateral by nature, i.e. ordinary, manual brokerage may be included in the definition. Finance Denmark would support, however, moving MiFID, art. 1(7) into MiFIR as it is (**no** rephrasing).

<ESMA_QUESTION_FOTF_3>

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

<ESMA_QUESTION_FOTF_4>

No. See comments to Q3 above.

<ESMA_QUESTION_FOTF_4>

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?

<ESMA_QUESTION_FOTF_5>

No. Finance Denmark does not agree with ESMA's proposal not to exempt smaller entities and in particular not if ESMA continues with the present proposals as presented in Q3 and Q4. Instead Finance Denmark strongly supports to include a principle of proportionality in the OTF authorisation regime which may be based on the level of activity falling into this category compared to the investment firm's overall activity.

<ESMA_QUESTION_FOTF_5>

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?

<ESMA_QUESTION_FOTF_6>

To operate an OTF with the embedded regulatory requirements in running a trading venue would require a certain size of organization as well as a business flow to justify such investment due to the economies of scale. This puts a certain limit on the number of viable OTFs (and trading venues) overall.

<ESMA_QUESTION_FOTF_6>

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?

<ESMA_QUESTION_FOTF_7>

We see a need to revisit Q10 in the ESMA Market Structure Q&A section 5.2, c.f. our response to Q3. Apart from that, we believe that there is too much level 3 guidance here, although it has so far been the result of poor guidance from the level 1 and 2 rules.

<ESMA_QUESTION_FOTF_7>

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.

<ESMA_QUESTION_FOTF_8>

Finance Denmark has heard there is a concern that the SIs market share has increased too much, and that SIs are acting multilaterally rather than bilaterally.

Firstly, we do not see a problem with an increasing role of SIs as long as the SIs business model is complying with the requirements in MiFIDII/MiFIR. One of the fundamental reasons for introducing quantitative requirements and opt-in possibilities for becoming an SI in MiFIDII/MiFIR was to move trading away from pure OTC/BCNs markets by increasing the number of SIs thereby strengthening the competition between execution venues and increasing transparency to the benefit of the clients and the efficiency of the capital market.

Secondly, we are missing documentation of the apparent, multilateral business model of some SIs. From a Nordic perspective, we cannot recognize this behavior. Finance Denmark is, however, open towards strengthening the description of the compliant SI activity and include this in level 2 regulation rather than in Q&As, if so needed. If ESMA's prevailing concern is in situations where two or more SIs cooperate and create de facto multilateral systems, we urge ESMA to focus on that and we urge that ESMA does not – also – prevent ordinary brokerage trading which has nothing in common with SI-crossing networks.

Thirdly, as for the SIs market share of trading, ESMA should bear in mind that the success of SIs to a large extent is due to the poor quality of the trading venues' order books, which is not supporting on-venue trading, and in particular not for larger size orders.[2]

For retail clients, SIs can provide immediate execution at a known price. For wholesale clients – such as pension funds - SIs can minimize market impact when executing larger orders, which trading venues in general are unable to support. This is not at least due to the in general poor quality of the trading venues' order books with low volume and undue interference from non-genuine "liquidity-providers" which is a consequence of e.g. inappropriate incentive schemes and insufficient tick sizes.

For all clients there is a wish to minimize costs and maximize return. There is no reason in punishing clients by forcing them to accept higher costs due to lower execution quality. This is not proper investor protection. Additionally, eliminating SIs as eligible execution places will diminish client choice and increase costs for end-users which is also contrary to the principles of MiFIDII/MiFIR.

Rather, Finance Denmark suggests enhancing the description of the SI activity in order to eliminate any doubts of what proper SI activity is. This should be implemented on level 1 or 2 instead of Q&As as is the case now, cf. our response to Q9.

<ESMA_QUESTION_FOTF_8>

[2] Finance Denmark's reponse to EC Consultation regarding MiFIDII/MiFIR Review (2020) and Appendix to Finance Denmark Response to EC Consultation regarding MiFIDII/MiFIR Review (2020)

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?

<ESMA_QUESTION_FOTF_9>

Following our response to Q8, Finance Denmark suggests enhancing the description of the SI activity in order to eliminate any doubts of what proper SI activity is. This should be implemented on level 1 or 2 instead of Q&As as is the case today.

- According to MiFIDII, article 4(1)(20), a systematic internaliser is an investment firm which, on an organised, frequent systematic and substantial basis deals on own account when executing orders outside a trading venue without operating a multilateral system.

- This is further explained in recital 17 in MiFIDII as well as recital 19 of delegated regulation 565/2017 which states that 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 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.

Here, it should be noted that no investment firm is allowed to facilitate a multilateral trading system without proper authorisation – no matter whether such investment firm is an SI or not. There are no particular prohibitions for SI trading. The present rules simply underline that the SI capacity does not increase the ability for an investment firm to carry out multilateral trading.

Finance Denmark suggests that the clarification of the level 1 and level 2 rules is formulated in line with the following considerations. This clarification will allow traditional OTC brokerage trading.

Like all investment firms systematic internalisers are required to act in the best interests of their customers (best execution) and one way to do that is by being an alternative to the trading venues, in particular in trading sizes below Large In Scale.

Part of being a systematic internaliser and acting in the best interest of the customers is to bring together trading interests when this can be done without establishing a system resembling the functioning of a trading venue. Key to defining this role is to define what constitutes “an internal matching system”. Trading venues have automated systems which assure that multiple trading interests can interact and be combined without human intervention. Thus, this should not be allowed when acting as a systematic internaliser. This would include automated systems which defer the trading so that the buying and selling

interests are not combined directly and simultaneously, but where a very short latency is added.

What should continue to be allowed is the manual handling where the systematic internaliser finds an opposite trading interest and combines a buy and a sell order. Such processes should not be seen as “a system” (nor as an “internal matching system”) since the processes are not automated and since by nature, they will always be ad hoc.

This situation will occur if for instance an investment firm is approached by a customer that wants to sell shares. To act in the best interests of the customer the systematic internaliser shall decide whether to route the order to a trading venue, or to buy the shares to its inventory or to try to find a suitable buyer. Trying to find a buyer in such a situation via a manual process does not resemble the way a trading venue functions in the trading of shares and it cannot be defined as meeting the definition of multilateral trading, nor will there be any rules that govern such matching of opposite trading interests. The clients do not face each other and have no access to a system where they can see each other’s orders. In short, the clients do not interact.

Please also see our general comments and responses to the previous questions.

<ESMA_QUESTION_FOTF_9>

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

<ESMA_QUESTION_FOTF_10>

Finance Denmark is of the firm opinion that software providers who replicates the functioning of an execution venue should be covered by the same rules that apply to the execution venues. In short, Finance Denmark supports ”same rules to the same business”. That said, please beware of our comment in the previous questions, where ordinary brokerage activity must not be coved by the multilateral definition.

<ESMA_QUESTION_FOTF_10>

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?

<ESMA_QUESTION_FOTF_11>

As Finance Denmark supports "same rules to the same business", we agree with ESMA's proposal – provided that there is the needed focus on whether the clients have had the possibility to interact thereby creating the basis for a multilateral system, cf. our comments to the previous questions.

<ESMA_QUESTION_FOTF_11>

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?

<ESMA_QUESTION_FOTF_12>

Finance Denmark has no comments.

<ESMA_QUESTION_FOTF_12>

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

<ESMA_QUESTION_FOTF_13>

Finance Denmark has no comments.

<ESMA_QUESTION_FOTF_13>

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.

<ESMA_QUESTION_FOTF_14>

Finance Denmark has no comments.

<ESMA_QUESTION_FOTF_14>

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?

<ESMA_QUESTION_FOTF_15>

Finance Denmark has no comments.

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?

<ESMA_QUESTION_FOTF_16>

Finance Denmark agrees.

<ESMA_QUESTION_FOTF_16>

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.

<ESMA_QUESTION_FOTF_17>

Finance Denmark has no comments.

<ESMA_QUESTION_FOTF_17>

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?

<ESMA_QUESTION_FOTF_18>

Finance Denmark has no comments.

<ESMA_QUESTION_FOTF_18>

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?

<ESMA_QUESTION_FOTF_19>

As stated above, Finance Denmark believes that traditional brokerage trading should be allowed for SIs as well as for other investment firms. Here, clients' buying and selling interests may be manually combined.

The definition of MPT and how this is linked to SIs' trading capabilities should not prevent that SIs conduct traditional brokerage trading.

The definition of MPT uses the term "that it is never exposed to market risk" and this has been used as an argument that SIs cannot conduct MPT since by definition SIs shall face market risk.

Thus, when clarifying the rules, it shall **either** be made clear that no matter the definition of MPT, SIs can act as brokers. **Or** it shall be made clear that MPT does not include the situation where the investment firm (the SI) enter into separate trades with separate clients even though the buy price and the sell price is the same. In this situation the investment firm (the SI) **will**

be exposed to market risk simply because it cannot be sure that the buying client can pay for the financial instruments and because the investment firm (the SI) cannot be sure that the selling client can deliver the instruments.
<ESMA_QUESTION_FOTF_19>

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)?
<ESMA_QUESTION_FOTF_20>

Finance Denmark does neither see a difference between MPT and riskless principal trading, nor does Finance Denmark see a difference between MPT and agency cross trades. There will always be an investment firm interposing itself in these kinds of transactions.

However, the terminology is not clear. As stated in the answer to Q19, an investment firm (SI) will be exposed to risk if it enters into two separate client transactions at the same price, even though the economic reality is that the investment firm (SI) sees the two transactions as linked transactions. None of these transactions can be seen as "riskless".
<ESMA_QUESTION_FOTF_20>

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?
<ESMA_QUESTION_FOTF_21>

Finance Denmark supports this clarification.

<ESMA_QUESTION_FOTF_21>