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	ICMA
Activity	Other Financial service providers
Are you representing an association?	☒
Country/Region	Europe

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_FOTF_1>

On behalf of the International Capital Market Association (ICMA), we are pleased to provide feedback regarding ESMA's, surprisingly wide scoped, consultation on the "functioning of the Organisd Trading Facility regime". ICMA's OTF taskforce is grateful for the opportunity to respond to ESMA's consultation paper. The ICMA OTF taskforce member response is based on mostly consensus view. However, on the occasion where there was not consensus view, it is noted. ICMA's OTF taskforce represents buy-side and sell-side investment firms, trading venues and software and technology providers. There is a unique value in conveying broad view from across the industry and we hope this response is informative and useful.

<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>

ICMA taskforce members consider the OTF regime has proved to be a positive new concept in MiFID II. It was effective because it did not disrupt the market and it acknowledged that 'voice' is a recognised trading system/method needing a specific regulation. This nuanced hybrid electronic/voice regime proved there are differences when compared with pure electronic market places. Furthermore, the OTF regime has shown the effectiveness of the human element of discretion and how it plays an important role in bond trading price discovery.

Lastly, ICMA members believe the OTF regime understands better how instruments outside equities trade.

<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>

ICMA taskforce members consider price discovery for illiquid bonds has lent itself well to the voice trading workflow of an OTF. OTFs are useful for block and or 'move to venue' trades as trades can be registered on a trading venue, bringing off-market activity 'on market'.

This is similar to what has been achieved through SI execution venues.

How do you see the OTF landscape evolving in the near future? More hybrid trading may occur with any changing market model. In addition, the number of OTF authorisations in the EU will increase.

<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>

The majority (consisting of mainly of buy-sides, sell-sides and software and technology providers) of ICMA taskforce members do not concur with ESMA's clarifications and does not agree with ESMA's proposals for amendments to level 1 or indeed further opinions or RTS.

Contrasting this, is the predominantly trading venue member view. These ICMA members agree with ESMA's proposed amendment of level 1.

There is however, consensus amongst all ICMA taskforce members that further clarification on the definition of trading venue would be very helpful. ICMA members however consider any future clarifications should take into account the following bullet points:

- ICMA is concerned that ESMA's interpretation of what is a 'multilateral system' might be too broad and does not define the regulatory perimeter with sufficient precision to avoid confusion among market participants. ESMA's interpretation, as currently stated on the CP, could disproportionately capture a number of fintech firms and software providers - including EMS, OMS and instant messaging. ICMA does not believe this is ESMA's MiFID II intention.
- ICMA Taskforce members carried out in-depth discussions about what should or should not be a 'multilateral system'. TheTaskforce agreed it is important to differentiate between real 'multilateral systems' and trading venues that bring multiple third-party buying and selling trading interests in bond instruments with the ability to interact together (including non-existing relationships) and infrastructures/technology used by sell-side and buy-side participants so that they can carry on their day to day activity more efficiently.
- ICMA members agree that there might be a need for further clarification. ICMA believes that the starting point should be to lay out clear principles of what constitutes multilateral trading such as 'many-to-many' interaction at any given point in time, bringing together 3rd party interests and facilitating an execution within the venue.
- The technology alone is not a sufficient criterion because technology can be used in a way that satisfies the criteria of multilateral trading or the same technology can be used in a non-multilateral context. It is important to look at the issue holistically.
- 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 to determine authorisation as a trading venue or not.
- With this approach it is important to ensure that technologies that are not 'multilateral' or facilitate 'trading' cannot get caught up in the MTF definition, inhibiting fintech advancement.
- Ultimately, this should be a supervisory and enforcement question and on a 'case by case basis' where national regulators engage with these tech providers and ensure they have the right permissions in place.
- ICMA believes that this is a complex issue. The consequences of getting this wrong could be very problematic for the EU market as a whole. It is therefore important to look at MiFID II with a new lens that both respects the role of trading venues and their authorisations but also allow innovation to strive.
- Finally, fintech arrangements and innovation should be promoted in the EU, making the region an attractive place to do business. Therefore, any fintech arrangements should be

treated carefully. Potentially forcing software and technology providers, incorrectly, to become trading venues could end up creating an unlevel playing field, stifling innovation and limititing competition in the bond market, and will ultimately lead to worse outcomes for EU end-investors. Nonetheless, if software and technology providers are not forced to be authorised as trading venues when they are behaving as a trading venue this too could cause an unlevel playing field.

Any additional ESMA consultation with industry members would be welcomed.

<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>

As stated above in question 3, ICMA taskforce members believe that MiFID should be looked at with a new lens – that respects both the role of trading venues and their authorisations while at the same time creating a space for innovation and software providers. Clearly delineating the regulatory perimeter with sufficient precision to avoid confusion amongst market participants would be useful. However, this is a complex issue that would necessitate further in-depth discussions with all market participants. We are concerned that an opinion issued by ESMA at this point would be premature given the level of complexity of this issue.

<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>

ICMA taskforce members agree with ESMA, there should be a regulatory framework for OTFs and there should not be an exemption for smaller entities.

Authorisation improves transparency in the marketplace and creates a level playing field.

<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>

N/A

<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>

No, ICMA taskforce members do not believe there should be further guidance. If execution or RTO onto OTF, participants are operating under the rules of the OTF.

<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>

No, ICMA taskforce members do not consider there is a network of SIs in bond markets.

<ESMA_QUESTION_FOTF_8>

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?

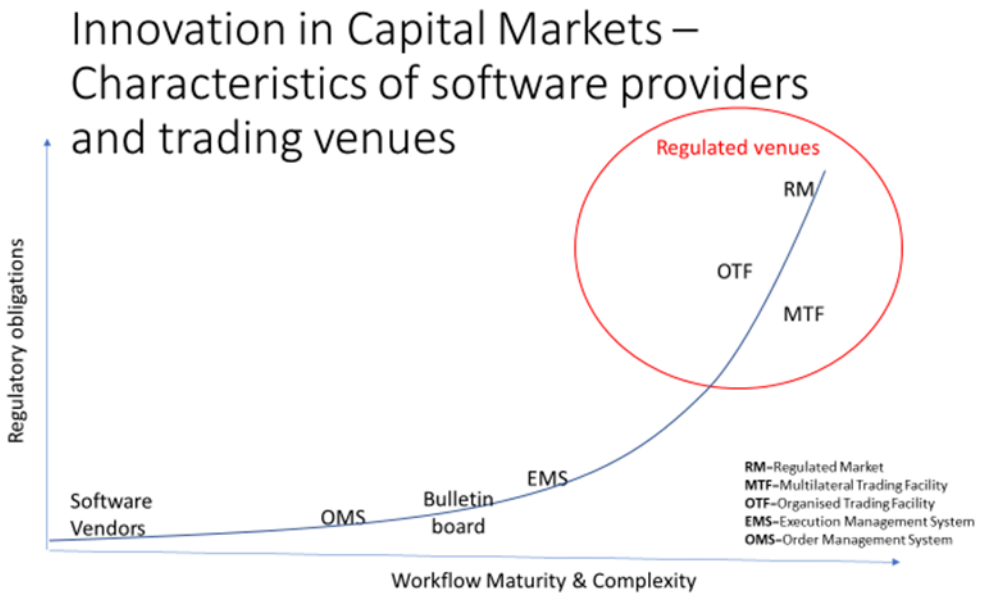
<ESMA_QUESTION_FOTF_9>

ICMA taskforce members believe the lines differentiating bilateral and multileral trading is sufficiently clear. In addition, ICMA taskforce members agree there should not be a level 1 amendment.

<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>



ICMA taskforce members view the main characteristics of multilateral as 'many to many' with interaction (bringing multiple buying and selling interests together, allowing interaction of those interests). In bond markets, the interaction in software is on a bilateral basis, as in any EMS or OMS, which routes trades bilaterally.

Taskforce members doubt that technology (software, routers, networks, billboards, email, chat messaging and voice etc.) is intended as the object of regulation by ESMA, unless it happens to somehow be 'making the decision to trade' through automation. This is all the more so as usually the decision to trade is taken between firms who are themselves regulated. In the case of an EMS or OMS, unless those systems are themselves somehow making trading decisions, it is normally the user (i.e. the trader who controls the trade, usually a member of a regulated firm) who does that.

Furthermore, ICMA taskforce members would like to point out, if ESMA does not have a clear distinction as to where the point of regulation begins, then where does ESMA draw the line?' For instance if a billboard, or an EMS or OMS that is wholly under the control of a trader, is now to be regulated, what is the point of difference in the regulatory boundary then with the telephone, chat or email?

ICMA taskforce members agree with ESMA's Q&A (q7 and 10): "an entity should seek authorisation to operate as a trading venue, OTF, MTF or RM where the three following conditions are met (all three not any of the three):

a) trading is conducted on a multilateral basis,

b) the trading arrangements in place have the characteristics of a

system, and

c) the execution of the orders takes place on a discretionary basis (OTF) through the systems or under the rules of the system."

If these three conditions are met, as stated in bullet point 8 in question 3, it will then be a case for enforcement and ensuring the right trading venue (OTF or MTF) authorisations are in place.

However, if these three ESMA Q&A conditions are not met and ESMA allows technology alone to be the criterion that forces authorisation of software and technology providers, then ICMA members are concerned. If the expectation of software and technology providers is that they will be prematurely forced to be authorised as an MTF or OTF in the EU, ICMA members believe this will drive software and technology innovation outside the EU to third countries.

Furthermore, If a fixed income software and technology provider aggregates bilateral indications and allows multilateral interaction with those aggregated indications, creating a 'many to many' marketplace, that is a multilateral facility and should be authorised accordingly as a multilateral facility (see answer to question 3, bullet point 8).

However, aggregation of bilateral indications (with no multilateral interaction) is still communication on a bilateral basis and does not require authorisation as a multilateral facility.

<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>

The pre arranging of transactions (bringing together buyers and sellers together and allowing interaction) should remain a separate licensable activity ('reception & transmission of orders'); no matter whether it's provided by software companies or other firms.

Ultimately, such transactions could be submitted to an authorised trading venue, all under the rules of a trading venue. Problems arise when firms that engage in multilateral activity, allowing interaction, are not regulated as a venue. This is the issue that ESMA should seek to address. ICMA took guidance from ESMA Q&A 11, 'MIFID II/R transparency topics'.

<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>

ICMA taskforce members agree that In fixed income, bulletin boards are electronic. The link between the bulletin board and the client is electronic and should be allowed. The electronic links 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.

Finally, ICMA 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.

ICMA taskforce members support a definition of bulletin board, taking into account point 80 in the consultation paper.

<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>

N/A

<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>

ICMA taskforce members consider some investment managers engage in internal crossing when they have funds that are buying and selling the same asset at the same time. The primary benefit for the funds is a reduction in execution cost.

The actual functionality of such internal crossing will vary greatly and it is hard to provide a general picture across asset managers. Most internal crossing functionality has in common that it employs technology to identify offsetting buy and sell orders which fund managers have already raised. This can be considered a replacement of manual trader checks with more technology-based checks, rather than a separate 'system' or 'platform' for crossing. Functionality will vary in its sophistication.

As ESMA points out, internal crossing typically gets done at midpoint which enables fund managers to avoid incurring unnecessary market impact. The amount of fees saved are a function of how big the blocks are and what types of assets are crossed. Without crossing, both the buyer and the seller would incur the full market impact, yet if crossed the order can be executed without impact.

The ability to cross internally is beneficial for end investors and enables them to reduce cost and improve their net investment performance.

It is a workflow internal to an investment manager.

<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>

ICMA taskforce members agreed that internal crossing between funds of the same investment manager should not be considered multilateral trading as it is purely internal to an investment manager.

When investment managers cross internally, either a fund manager or a trader has typically identified offsetting buy and sell orders. They would then internally cross these orders to avoid unnecessary execution activity and execution cost within their remit of delivering best execution. This is similar in spirit to aggregating two buy orders into one single order to optimize the execution. There is no economic involvement of any third party interest in the matching process; it is also not multilateral or all-to-all in nature.

ICMA members agreed that the current rules for MTFs or OTFs are sufficiently clear in ruling out that internal crossing should be considered 'trading venue' functionality. A Level 1 change is not necessary.

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>

ICMA taskforce members agree with ESMA's interpretation and do not think it should be further clarified.

<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>

ICMA OTF operators apply discretion equally to placement and execution of orders. The equal treatment of discretion is due to the hybrid voice/electronic nature of an OTF system.

<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>

ICMA taskforce members consider there can be an appearance of less transparency, however this is misleading as the rules are in the Rulebook of the OTF or on its website. The discretion is used for the best interests of the clients and is in line with best execution policies or a separate discretion policy. The best execution policies can be found either on websites or in the OTF rulesbooks or both. If not, discretion and best execution should be accessible by clients at all times.

<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>

ICMA taskforce members agree with ESMA. There should not be any further clarification to MPT.

<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>

ICMA taskforce members consider the incentive to trade MPT is anonymity and fee structure.

<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>

ICMA taskforce members agree with ESMA's proposal to clarify further.

<ESMA_QUESTION_FOTF_21>