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Global Market Structure – Europe

Execution Excellence

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MiFID II: Definition of Systematic Internalisers and Industry Response to EC Consultation

Briefing Note

What has happened?

On June 20, 2017 the European Commission launched a consultation to seek industry feedback on a proposal to amend the definition of Systematic Internalisers (SI). The consultation closed on July 18, 2017 and a number of participants sent their feedback. See appendix 1 for a brief summary of participant feedback, and appendix 2 for a timeline of events.

By way of an amendment, the EC proposed to restrict the scope of the phrase 'dealing on own account' in the definition of SI to exclude riskless back-to-back transactions.

Background

EC's consultation comes as a response to settle the ongoing debate about whether or not SIs should be allowed to engage in matched principal (MPT) and other forms of riskless back-to-back trading. The debate began soon after the publication of MiFID II text that unconditionally allowed SIs to conduct MPT. Concerns around MPT by SIs were first raised by the Federation of European Securities Exchanges (FESE) way back in December 2014 in response to an ESMA consultation.
FESE claimed that conferring absolute freedom upon SIs to conduct MPT would allow them to continue BCN-type activity (broker crossing networks), and this would amount to multilateral trading with lenient transparency obligations. Their contention was that this setup defeats the spirit and purpose of transparency provisions in MiFIR, as SIs are only required to be pre trade transparent in sizes upto Standard Market Size (SMS).

In response to FESE's submissions, the legislators imposed a partial restriction on MPT by SIs in Recital 19 of Commission Delegated Regulation 2017/565. The recital states that SIs may conduct MPT on an occasional basis only and in any event must not operate a (multilateral) internal matching system[1]. Inclusion of the recital did little to allay the concerns of market operators, because recitals are not legally binding and are only good for their persuasive value. The binding parts of the Delegated Regulation remain silent on this issue.

In December 2016, this issue was picked up again by a Member of European Parliament in a letter addressed to the European Commission. After a series of letters among the EC, ESMA and the

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[1] Level 1 definition (Article 4(1)(20), MiFID II) is very clear about this aspect and does not envisage a situation where an investment firm operating a multilateral system to execute client orders is allowed to trade in a 'Systematic Internaliser' capacity.

European Parliament, in April 2017, ESMA published a list of dos and don'ts for SIs around this issue (ESMA Q&A Section 5.3 nos 17, 18). ESMA did not impose a blanket ban on MPT, but allowed SIs to only engage in MPT that is 'accidental'. While the industry was still grappling with ESMA's guidance, the EC went a step further and launched the consultation with a view to ban all forms of '*de facto* riskless back-to-back trading' by SIs.

On July 18, 2017 the EC published participant feedback and it's apparent from these responses that the proposal raises more concerns than it dispels. Clearly, there is still some way to go before this issue is resolved. In this document, we highlight important points raised by some participants in their responses.

What are they amending?

The EC have proposed to insert Article 16a in the Delegated Regulation to restrict the scope of the phrase 'dealing on own account' to exclude *de facto* riskless back-to-back transactions (hereinafter 'riskless trading') in a financial instrument. If the amendment is adopted, the definition of SI will effectively be changed as reproduced below:

"Systematic internaliser" means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system. [Article 4(1)(20), MiFID II]

An investment firm shall not be considered to be dealing on own account for the purposes of Article 4(1)(20) of Directive 2014/65/EU where that investment firm participates in matching arrangements entered into with entities outside its own group with the objective or consequence of carrying out de facto riskless back-to-back transactions in a financial instrument outside a trading venue." [Article 16a, Delegated Regulation]

Before we delve any deeper, it is important to note the sharp contrast in the approach adopted by the EC to tackle this issue. Hitherto, legislation and ESMA guidance sought to 'prohibit' riskless trading by SIs, albeit, within the parameters of the SI regime. Conversely, the EC's proposal is to 'de-scope' or 'deregulate' riskless trading and take such trades out of the SI regime altogether. *Prima facie*, this means that riskless trades (including matched principal trades) concluded by investment firms outside the rules of a trading venue will never qualify as 'dealing on own account', and hence not count towards such investment firms' SI calculations. We will look at the implications of this change in approach in more detail later in this document.

What is the impact on broker-dealers?

The Association for Financial Markets in Europe (AFME) in their response highlight the potential impact of the amendment on investment firms that operate in dual capacity, i.e. broker and dealer. AFME emphasise that the SI regime seeks to only regulate the 'dealer' capacity of an investment firm; and brokerage activities of such firms should continue to remain unaffected by this proposal.

AFME's concern is that a broad interpretation of the '*prohibition on participating in matching arrangements*' could capture the brokerage activities of broker-dealer firms. If such an interpretation is adopted, this would mean that firms that act in dual capacity would not be able to access all available liquidity on behalf of their clients, as opposed to other pure agency brokers who would be able to access liquidity provided by SIs. Such an interpretation would seriously hurt investor interest and the ability of broker-dealer firms to provide best execution to their clients. Therefore, AFME strongly advocate a narrow interpretation of this phrase and reiterate that SI regime should only apply to investment firms when acting in the capacity of 'execution venues' for a trade and not where they act as brokers passing on a client order to another SI for execution.

What is the impact on prudential risk management?

In their reply, AFME bring attention of the reader to the impact the amendment could have on prudential risk management of firms. A literal reading of '*prohibition on carrying out de facto riskless* *back to back transactions*' could be interpreted to mean that SIs will never be allowed to hedge or unwind the risk they take on by executing client orders. AFME contend that SIs can certainly not accumulate risk they assume by internalising client orders and need to execute back-to-back transactions to effectively transfer and manage risk. Failure to manage risk will result in build-up of systemic risk in the market and such restrictions are also likely to discourage investment firms from providing liquidity in SI capacity. Further, AFME argue on similar grounds that back-to-back transactions should be allowed between sister firms to effectively manage risk at a group level.

The responses from Tower Research Capital Europe Limited, International Swaps and Derivatives Association (ISDA) and Managed Funds Association (MFA) echoed the views stated above.

Following the consultation process and feedback from participants, the EC published their final amendment text on August 29, 2017. In the final text, the EC have inserted wording and a recital which clarifies that intra-group risk transfers are not within the purview of this amendment and should continue to be permitted and treated as 'dealing on own account'. The final text of the amendment is subject to scrutiny by the legislators for a period of three months which may be extended by another three months. If the amendment is adopted, it shall enter into force on the day following its publication in the EU official journal.

Nasdaq and FESE in their responses supported the amendment and also pointed out that SI regime should be aligned with the tick size regime in order to restrict SIs from offering marginally better prices to clients. The other point they raise is about the time restriction on SIs to publish trade reports. SIs are required to publish trade reports within 1 minute of execution, which in their opinion gives SIs a considerable advantage over market makers that provide liquidity on trading venues.

What is the impact on instruments not subject to trading obligation?

MFA raised some pertinent points about the impact of the amendment on instruments that are not subject to the trading obligation. They appear concerned that excluding riskless trading from the purview of 'dealing on own account' is likely to negatively constrain the evolution of SI regime in fixed income, ETF and derivatives markets.

MFA's argument is that instruments not subject to the trading obligation may be traded by firms outside the rules of an SI or a trading venue. Adopting the amendment would mean that riskless trades concluded by investment firms will never be considered as 'dealing on own account' and therefore such trades will not count towards SI thresholds/ calculations of such firms. For instance, firms regularly transacting on a riskless OTC basis in ETFs may never become SIs and hence, may never have to comply with pre trade transparency obligations.

Therefore, MFA contend that investment firms would have the option to execute transactions in such instruments on a purely riskless OTC basis without ever being subject to the SI regime. As a consequence, the desired transparency in such instruments may prove difficult to achieve. Additionally, it is argued that such firms will not be required to produce RTS 27 reports and this would leave a gaping hole in the Best Execution framework. These considerations render the amendment effective only for instruments for which there is an obligation on firms to trade them on transparent execution venues[2]; i.e. shares and certain derivatives.

MFA also urge the EC to reconsider their approach to solve this issue. The relevant extract from the response is reproduced below:
"Based on the foregoing, we suggest that the Commission reconsider its approach to the issue. In particular, we support an approach whereby any proposed changes to the definition of SI define certain activities that cannot be undertaken under the SI regime, rather than generally excluding a range of transactions and activities from the SI regime."

[2] Regulated Markets, MTFs, Equivalent 3rd Country Venues and Systematic Internalisers for Shares; Regulated Markets, MTFs, Equivalent 3rd Country Venues and OTFs for Derivatives.

How does the amendment create internal logical inconsistencies and legal uncertainties?

MFA argue that the amendment, if adopted, would introduce internal conflict between Level 1, 2 and 3 texts which would ultimately create legal uncertainty for participants. They highlight 3 such discrepancies in texts as described below:

1. The amendment is in direct conflict with Recital 24 of MiFID II which says Matched Principal Trading should be regarded as 'dealing on own account'. It should be noted that under the proposal Recital 24 would not be repealed but retained in Level 1 text as is. Recital 24 is copied below:

   "Dealing on own account when executing client orders should include firms executing orders from different clients by matching them on a matched principal basis (back-to-back trading), which should be regarded as acting as principal and should be subject to the provisions of this Directive covering both the execution of orders on behalf of clients and dealing on own account."

2. In Level 1, 2 and 3 texts, the authorities have used several terms to describe riskless trading, and such use of multiple terms creates confusion and lends itself to speculation. In Level 1 text legislators use 'Matched Principal Trading', ESMA Q&A use 'riskless back-to-back transactions' and the proposed amendment uses the term '*de facto* riskless back-to-back transactions'. Similarly, Level 1 refers to a 'multilateral system', Level 2 uses the term 'internal matching system' and the amendment mentions 'matching arrangements'. Whether all these terms are different or identical – in law or in fact or both – is not described anywhere and this creates legal uncertainty for participants.

3. The amendment proposes to take riskless trades out of scope of the bilateral SI regime. Recital 7 of MiFIR already took such trades out of scope of the multilateral regime. Given that riskless trades are not to be governed by rules for multilateral systems and now bilateral systems as well; there is legal uncertainty about how such trades will be regulated. Extract of Recital 7, MiFIR is reproduced below:

   "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. <u>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</u>."

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- Topic 1, Update 1 MiFID II – Trade and Transaction Reporting
- Topic 2, Update 1 MiFID II – Systematic Internalisers, Trading Obligation and MPT
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- Topic 5 MiFID II – Research Unbundling
- Topic 6, Update 1 MiFID II – Impact on Non-Equities
- An Overview of MiFID II
- Directory of Documents

Appendix 1

Participant feedback

Participant	Key Quote
Federation of European Securities Exchanges: FESE (Belgium)	*FESE strongly supports the proposed draft Commission Delegated Regulation which should close one of the loopholes. We believe the proposed Article 16a deals both with the 'internal' riskless trading (on a single SI) and the 'external' riskless trading (across multiple SIs), regardless of whether such activity is pre-arranged via interconnected networks or more informal, e.g. via 'pinging'. At the same time, genuine activity such as portfolio trades or swaps/CFD trades, will not be captured by the proposed changes.* *….* *The capacity of SIs to improve prices without respecting tick sizes means they will be able to offer (often meaningless) price improvement to their clients. In conjunction with best execution requirements, this means SIs are extremely likely to capture significant trading flows in the post-MIFID II market structure.* *….* *The objectives of MiFID II are severely threatened by three major loopholes giving an unfair and unjustified advantage to trading on SIs. Should these loopholes not be addressed, there is a high risk the unintended consequence of MiFID II will be a fundamental change of market structure away from public, transparent, and multilateral markets to private, opaque, and bilateral liquidity pools*
Better Finance (Belgium)	*BETTER FINANCE strongly supports the proposed draft Commission Delegated Regulation. We believe that Article 16a is relevant in order to deal with the "internal" riskless trading – on a single SI – and the "external" riskless trading – across multiple SIs, regardless of whether such an activity is pre-arranged via interconnected networks or more informal (such as via "pinging"). Simultaneously, genuine activities, such as portfolio trades or swaps/CFD trades, will not be included in the proposed changes.* …. *We would also like highlight for the Commission another potential loophole in respect of the SI regime, namely tick sizes. The capacity of SIs to improve prices without respecting tick sizes means they will be able to offer (often meaningless) price improvement to their clients. In conjunction with best execution requirements, this means SIs are extremely likely to capture significant trading flows in the post-MIFID II market structure. This unlevel playing field is not justifiable; SIs should be subject to the same obligations as trading venues in this respect.*
Association for Financial Markets in Europe: AFME (United Kingdom)	*We believe the legislative intent of these proposed amendments is to ensure that investment firms when dealing on own account when executing client orders are genuinely taking on risk. We are supportive of this aim, however, we remain concerned that the drafting as proposed is broad and open to interpretation such that we foresee a number of unintended consequences.* *….* *It should be clear that brokerage activity is distinct from execution activity, and both should continue to be permitted. Any new delegated legislative provision should only seek to restrict riskless back-to-back transactions in the scenario where as SI is treating itself as, and holding itself out as, the*

Participant	Key Quote
	execution venue for the trade (as opposed to where the broker is passing a client trade to another SI/execution venue).
[Anonymous Company (Netherlands)]	*Based on recent observations, we anticipate the primary model will be agency brokers order-routing client flow to liquidity provider SIs on a bilateral basis, or an SI interacting directly with clients, rather than two SIs interacting back-to-back via a 'network of interlinked SIs.* *….* *It will be plausible that SIs will execute bilaterally and take risk on book while actual exposure may still be extremely limited (professional LPs have many ways to manage exposure, including indirect hedging by trading correlated products or hedging on a portfolio basis across different timeframes), especially considering how "valuable" the relatively uninformed client flow is to the SI and the transparency advantage the SI has over the public market.* *….* *We note some have expressed concern that the prohibition on SIs engaging in "internal" or "external" matching would constrain intra-group risk management activities. By contrast, we believe this clarification may help reduce the chance that SIs will offload SI risk intragroup to non-EU entities in order to minimize or avoid EU prudential requirements.* *….* *We echo earlier comments calling for the need to address the core elements making the SI regime inherently – and inadvertently –more attractive than lit markets:* *1. SIs can price improve out of compliance with the tick size regime (better price);* *2. transparency is limited (market impact will be limited); and* *3. executions will not be subject to transaction fees (lower costs).* *These elements will likely mean transactions on SIs achieve de facto Best Execution based on an unlevel playing field with public markets. /* *SIs are not explicitly included in (nor explicitly excluded from) the scope of tick sizes under MiFID2/R. In light of MiFID 2's trading obligation for equities which treats trading venues and SIs on equal footing, this is no longer justified. SIs will too easily be able to price improve compared to public markets – even when executing in small sizes. Above standard market size, nothing will restrict SIs' ability to price-improve. When combined with, as others have pointed out, SIs' ability to cherry pick client order flow and send only the most sophisticated or "toxic" order flow to the public market, it means market makers who post firm and transparent orders on the public order book will not only fail to see any reward, they will actively be exposed to risk*
[Tower Research Capital Europe Limited]	*Firms have at this point dedicated significant financial and human resources towards preparing for MiFID 2, including the SI regime, on the basis of the published text and the timing of these proposed changes alongside other recent "guidance" creates significant uncertainty for market participants.* *The most appropriate time to make any necessary changes to the SI regime would be 6-12 months following the implementation of MiFID 2.* *….* *Regarding the specific proposal subject to the current consultation, we would echo the views of some other respondents in that we believe the proposed additional wording could create further confusion. Tower believes that all Investment Firms should have a robust risk management*

Participant	Key Quote
	framework and we believe elements of the Commission's current draft runs contrary to what we see as sound prudential risk management practices.
Managed Funds Association (United States)	*MFA is concerned that, in the case of asset classes for which the trading obligation does not apply, a large volume of such transactions will be concluded outside a trading venue and outside the SI regime and thus would not be subject to any pre-trade transparency regime. As a result, there would be a loss of transparency for such transactions. We do not believe this outcome is consistent with the intention of the Commission and co-legislators when agreeing on MiFID II, and creates significant transparency concerns.*
French Banking Federation (France)	*FBF believes that riskless back-to-back trading should be allowed between entities of the same group and, consequently, that such arrangement should be prohibited only with entities that are not members of the same group as the systematic internaliser.* *For operational, commercial or risk management policies, an investment firm may be entitled to set up, for the same asset class, two (or more) systematic internalisers arrangement(s) in distinct legal entities and possibly in different jurisdictions.*
AMAFI (France)	*AMAFI shares EC analysis that the linking of several investment firms operating under the systematic internaliser regime with other liquidity providers, under a matching arrangement, or in such a way that this linking has the same results as a matching arrangement, may end up with a circumvention of MiFID 2.* *Nevertheless AMAFI considers that it should be possible to organise riskless back-to-back transactions between systemic internalisers within a same group, provided that the group does not put in place riskless back-to-back transactions arrangements with undertakings that are not members of the same group as the investment firm*
International Swaps and Derivatives Association (United States)	*We note the European Commission's concern regarding interconnected systematic internalisers replicating broker crossing networks (BCNs), particularly in shares, without being regulated as a systematic internaliser or trading venue.* *As drafted, however, we have concerns that the proposed wording could be interpreted to restrict the ability of investment firms to act as brokers, for example where a trade may be passed to another execution venue. Such a restriction would significantly impair the ability of an investment firm to access liquidity on behalf of their clients, and manage its risk.*
Nordic Securities Association (Finland)	*Furthermore, the provision also covers the non-equity market. This wide scope came as a surprise to NSA, taking into account that the problem which was identified and described in letters from both ECON - Mr. Maijoor - to the Commission as well as in the Commission's reply, clearly related to broker crossing networks and interconnections between SIs and other liquidity providers on the equity market.*
CFA Institute (Belgium)	*We believe that the role of regulators is to ensure a level playing field for market participants and to minimise the amount of regulatory arbitrage that incentivises participants to misallocate resources. To this end, we are supportive of the Commission's proposed amendment to Article 1 of Delegated Regulation 2017/565 to not consider a firm to be dealing on its own account (i.e. acting as a systematic internalizer) when that firm participates in activities that result in de facto riskless back-to-back transactions outside a trading venue.*

Participant	Key Quote
Optiver (Netherlands)	*If SIs are treated as a venue for the purpose of meeting the share trading obligation, it is difficult to justify why SIs are not subject to the same obligations when it comes to the tick size regime. But MiFID2/R allows SIs to easily price improve as compared to public markets by potentially infinitesimal amounts (e.g. a price improvement of 1/100 of a cent) – and transact inside the best bid/offer. This meaningless price improvement will however make SIs the de-facto destination of choice for Smart Order Routers (SORs) seeking best execution, but in the long term, at great cost for the public markets' role in central price formation.*
Nasdaq	*First, the ability of SIs to improve prices without respecting tick sizes means SIs will be allowed to offer marginally better prices to clients. In conjunction with best execution requirements, this means SIs are extremely likely to capture significant trading flows. Second, control over the timing of trade publication on SIs (up to 1 min) will give SIs a considerable advantage over market makers on public markets. If these loopholes are left unchecked, there is a risk of an unintended consequence of MiFID II in the form of a fundamental change of market structure away from public, transparent, and multilateral markets, to private, opaque, and bilateral liquidity pools.*
Anonymous (United Kingdom)	*We are not aware of any network of systematic internalisers and liquidity providers holding themselves out in the market as a single systematic internaliser. Thus we cannot comment on the objectives of the new Article 16a.….however….we are concerned that the provision may be applied to unduly constrain how systematic internalisers manage the risk they take on in dealing bilaterally with other market participants.*
Anonymous (United Kingdom)	*By undertaking risk-facing transactions, SIs are a valuable source of liquidity to market participants. …..We are pro-competition and support the right of market practitioners to innovate and apply technological solutions to regulatory challenges in the interests of efficiency and customer choice (so long as these can be demonstrated to be regulatory compliant). We believe there should be no protectionist tone directed at market practitioners who seek to innovate.*

Appendix 2

Timeline of Events

Date	Document/ Provision/ Source	Event
15th May, 2014	Recital 24, MiFID II, Definition of SI (Article 4(1)(20), MiFID II) and MPT (Article 4(1)(38), MiFID II)	Level 1 unequivocally allows SIs to conduct MPT- without placing any restriction on the frequency or quantum
19th December 2014	FESE response to ESMA consultation on MiFID II/ MiFIR Provisions	- FESE object to Level 1 text about potential exploitation of the freedom afforded to SIs to conduct MPT - Raise concern about SI regime comfortably accommodating BCN- type activity - Dispute the bilateral nature of SI activity; allege that in MPT, SIs interpose themselves for "fraction of time" and take limited to no market/ counterparty risk - Claim that unrestricted MPT by SI would tantamount to "*OTF category within the equities space*"
Sometime in 2015	Recital 19, Delegated Regulation	- Level 2 (non binding) recital states that SIs may not conduct MPT on a "regular and not occasional" basis - There is no further mention of this issue in rest of the Delegated Regulation - Meaning of phrases " functionally the same way as a trading venue" and "regular and not occasional basis" are not elaborated
13th December 2016	Letter to the EC by an MEP	- MEP informs the EC that certain brokers and liquidity providers are trying to replicate BCNs using a network of SIs - He states that an arrangement with interconnected SIs would operate in functionally the same way as a multilateral system - He also argues that this arrangement goes against the spirit of transparency provisions in MiFID II as SIs are only required to be pre trade transparent in sizes upto SMS
1st February 2017	ESMA's letter to the EC	- ESMA approach the EC and warn them about certain investment firms intending to use interconnected SIs to operate as BCNs. - ESMA don't want SIs to engage in riskless trades and emphasise that SI regime is characterised by "risk" facing trades - ESMA expand the scope of their scrutiny and "other types of back-to- back transactions" are added to the discourse (until now it was limited to MPT) for the first time
16th March 2017	Letter from the Vice President of the EC to MEPs	- EC acknowledges concerns of market operators about interconnected SIs and potential circumvention of MiFID transparency rules - EC propose to engage in dialogue with ESMA and NCAs to agree an EU wide approach
3rd April 2017	ESMA Q&A	ESMA issue 2 Q&A and define what they will treat as "riskless back-to-back trading" and " regular and not occasional basis"

20th June 2017	EC's consultation on amending definition of Systematic Internalisers	- EC launch consultation and propose to further qualify the definition of Systematic Internalisers - This time they want to preclude SIs from engaging in "*de facto* riskless back- to- back transactions" – the full impact of this amendment is debatable; but it can be said with some certainty that it goes beyond "riskless back-to-back transactions" - The proposed amendment also restricts SIs from entering into "matching arrangements"- likely wider application compared to earlier prohibition on running "internal matching system"
18th July 2017	EC publish feedback from participants	- A number of Investment firms and market operators make representations to the EC - Investment firms submit their views about impact on dual capacity of investment firms i.e. broker and dealer, intra-group risk transfers and more generally, the SI regime - Market operators support the amendment and reiterate their stance on alignment of SI regime with the harmonised tick size regime
28th August 2017	EC publish final draft amendment text	- EC finalise their draft amendment text and clarify the position on intra-group risk transfers - This text will be put to the legislators for their scrutiny. For this, they have a period of 3 months which they may extend by another 3 months

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