NORDIC SECURITIES ASSOCIATION

MEMO

NSA response to the proposal from the Commission in order to amend the MiFID 2 Delegated Regulation with respect to systematic internaliser definition

The Nordic Securities Association (NSA) is a Nordic cooperation that works to promote a sound securities market primarily in the Nordic region. The NSA is formed by the Danish Securities Dealers Association (Børsmæglerforeningen), the Federation of Finnish Financial Services (Finanssialan Keskusliitto), the Norwegian Securities Dealers Association (Verdipapirforetakenes Forbund) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen).

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Summary

On 20 June 2017, the Commission published a proposal with a 4 week consultation period to amend Delegated Regulation (EU) 2017/565 with the purpose to clarify the precise scope of the definition of "systematic internaliser" to ensure uniform application of this term and avoid circumvention. The Commission's focus is to restrain the increasing OTC trade in equities within the so-called Brokers Crossing Networks (BCN), which in their essence are OTC dark pools.

However, the proposal is not targeted towards this concrete challenge; it is much wider in scope, which may lead to unintended consequences i.e. less efficient markets for all instruments.

In order to accommodate a more targeted approach, the NSA has provided a concrete proposal for amendment, which can be found on page 3.

General comments

The NSA notes that the proposed amendment to the Commission's delegated regulation EU/2017/565 ("delegated regulation") is intended to take care of what has been referred to as a "loophole" in MiFID2/MiFIR, relating to broker crossing networks. According to recital 2, the intention is to deal with the *"the emergence of electronic communication networks that allow for the linking of several investment firms that intend to operate under the systematic internalization designation with other liquidity providers engaging in high algorithmic trading techniques".*

The NSA agrees that such networks of electronically interconnected SIs and other liquidity providers/high frequency traders which are referred to in recital 2 would normally fall outside of bilateral own account trading that SIs engages in when executing client orders. Therefore we have no objection per se that this principle is clarified with a targeted amendment to level 2.

However, in the opinion of NSA, the proposed amendment to the delegated regulation has been given a much wider scope than the problem(s) it intends to address. In fact, in the proposed article 16 a) of the delegated regulation there is no mentioning of networks/linkages of SIs with other liquidity providers engaging in high frequency algorithmic trading techniques. 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[1] - Mr. Maijoor[2] - to the Commission as well as in the Commission's reply[3] , clearly related to broker crossing networks and interconnections between SIs and other liquidity providers on the equity market.

The NSA fears that the proposed wide scope of article 16 a) could have some unintended consequences for the non-equity market. In particular this would be the case if the provision is to be interpreted as limiting the possibilities for SIs to execute client orders in instruments which they are not holding on their books at the time a request-for-quote is made by a client[4] or by making it more difficult for SIs to hedge their risks. This could in turn have a direct impact on the liquidity and well-functioning bond markets in EU, in particular the corporate and covered bond markets. In this connection, the NSA would like to underline that from an implementation perspective (building of IT systems, business strategy decisions, information to clients etc.) it is very late in the process to fundamentally change the conditions under which firms may conduct business under MiFID2/MiFIR.

Based on the above concerns, the NSA proposes that the Commission take a cautious approach and focus on a more targeted amendment of level 2. This could be achieved by aligning the wording of article 16 a) to recital 2 and the contents of above-mentioned letters, e.g. to insert references in the paragraph to matching arrangements with other liquidity providers which engage in high frequency algorithmic trading. The suggested change would ensure that the scope of the provision does not go beyond the regulatory intentions and risk causing unintended, negative consequences for investment firms and their clients.

Proposed change

"Article 16a *Participation in matching arrangements* *An investment firm shall not be considered to be dealing on own account for the purposes of Article 4(1)(20) of Directive*	*"Article 16a* *Participation in matching arrangements* *An investment firm shall not be considered to be dealing on own account for the purposes of Article 4(1)(20) of Directive*

[1] http://www.europarl.europa.eu/cmsdata/114743/D(7018)-Dombrovskis%20-MiFID%20II-SIs%20operating%20broker%20crossing%20networks.pdf
http://www.europarl.europa.eu/cmsdata/116783/D(15409)-Dombrovskis%20-Follow-up%20on%20MiFID%20II-SIs%20operating%20broker%20crossing%20networks-WdJ.pdf
[2] https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-19_letter_chair_guersent_si_0.pdf
[3] http://www.europarl.europa.eu/cmsdata/115881/re-MiFID%20II_VD_13-03.pdf
[4] On the corporate bond market in the Nordics, market makers are often approached by clients requesting to buy/sell a corporate bond which the investment firm does not currently hold on its books. In those cases, the investment firm will go out on the market to find "the other leg". This could either take place on a trading venue or through another investment firm/SI (best execution rules will decide). The investment firm will then enter into two separate bilateral trades - with different prices - by trading on own account with the requesting client and the other party. There is no prior "matching arrangement" between the investment firms

2014/65/EU where that investment firm participates in matching arrangements with the objective or consequence of carrying out de facto riskless back-to-back transactions in a financial instrument outside a trading venue".	*2014/65/EU where that investment firm participates in matching arrangements, whether internal or external with other liquidity providers engaging in high frequency algorithmic trading techniques with the objective or consequence of carrying out de facto riskless back-to-back transactions in a financial instrument outside a trading venue as defined in MiFID2, art. 4 (1)(39).*

Specific comments

The NSA finds the article 16 a) unclear in some respects and would welcome further clarifications by the Commission. Otherwise there is a significant risk that this provision will be subject to different interpretations in the Members States, which would create an un-level playing field between investment firms and undermine the Single Rule Book. Please also note that the very short time that is left before the MiFID2/MiFIR will enter into force makes it very urgent that these clarifications are provided in connection with the Commission's feed-back statement (not wait for ESMA to clarify on level 3).

1. The NSA notes that the implications of article 16 a) depends on how the various terms are to be interpreted. For instance "matching arrangements" is not a defined term in MiFID2/MiFIR. According to our interpretation, this term implies some sort of pre-determined and organized set-up. This can either be internal within the investment firm (e.g. broker crossing networks) or external (e.g. though a network with other liquidity providers). Please confirm.

   Moreover, the words "de facto riskless" and "back to back transactions" could benefit from clarification. In this connection it should also be described what the difference (if any) is between "riskless back-to-back transactions" and "matched principal trading" in MiFID2, article 4 (1) (38). In our understanding there should be no difference and the definition in MiFID2, art. 4 (1) (38) is clear.

2. According to its wording, article 16 a) regulates which trades are considered to be SI-trades by stating that "de facto riskless principal back-to-back trading" shall not be considered as such own account trading referred to in article 4.1 (20) MiFID2/MiFIR. Thus, to our understanding, article 16 a) does not explicitly prohibit the investment firm from undertaking these type of transactions but states that the transactions should not be considered as own account trading under the SI-rules. On the other hand, recital 2, states that it is "necessary to specify that a systematic internaliser is not allowed to engage, on a regular basis, in the internal or external matching of trades via matched principal trading or other types of de facto riskless back-to-back transactions". In our view this creates a contradiction between the recital and the article, which results in uncertainty regarding this question. Please confirm the intention.

3. It is our understanding that the intention of article 16 a) is that investment firm cannot enter into "de facto riskless back-to-back" transactions on a regular basis when executing client orders in shares subject to the trading obligation in article 23 MiFIR. The reason for this is that such transactions may only be executed on venue or SI and it follows from art 16 a) that a "de facto riskless back-to-back transaction" is not to be considered an SI-trade according to article 4.1 (20) MiFID2/MiFIR. Please confirm.

   However, it would be possible to execute "de facto riskless back-to-back transactions" when the investment firms relies on the possibilities to trade shares OTC in accordance with article 23.1 a) MiFIR. Please confirm.

4. Article 16 a) furthermore implies that "de facto riskless back-to-back transactions" shall not be included when an investment firm is calculating whether its OTC trade when trading on own account has met the SI thresholds in articles 12 – 16 of the delegated regulation. Please confirm.

5. The wording of article 16 a) states that de facto riskless back-to-back transactions shall not be treated as dealing on own account when executed outside a trading venue. To our understanding it is however possible for firms to execute such transactions which is carried out outside a venue but under the system/rules of a venue, subject to a pre trade waiver such as negotiated trade waiver or LIS. According to recital 7 MiFIR and ESMA Q & A[5], such transactions are to be considered as executed "on venue". Please confirm.

[5] ESMA Q & A Transparency, Question 3 c) dated 31/01/2017