



Alternative Investment Management Association

ESMA
103 rue de Grenelle
75007 Paris, France

[submitted electronically]

1 August 2014

Dear Sirs,

The Alternative Investment Management Association¹ (AIMA) welcomes the opportunity to respond to the European Securities and Markets Authority's (ESMA) Discussion Paper² (DP) and Consultation Paper³ (CP) regarding the MiFIDII/MiFIR regime. We appreciate ESMA's efforts to solicit industry feedback, whilst also respecting the tight timescale established in the primary legislation, and encourage ESMA to continue its dialogue with industry participants over the coming months to ensure that secondary legislation is well considered and achieves the aims of the primary legislation, including the desire to strengthen and deepen the operation of the internal market.

Given the breadth of the issues raised in the CP and DP, we include in Annex 1 a brief overview of some of the points raised in our submission. At the highest level, we would characterize our position as follows:

- We support the drive to make markets more efficient and explore in detail the role that straight-through processing of cleared OTC derivatives transactions can play in this regard. At the same time, however, we consider the way in which other components of the MiFIDII framework, including position limits and rules on algorithmic trading and high-frequency trading, can be calibrated and applied in a proportionate manner that does not undermine the functioning of markets or create barriers to entry that will harm competition.
- AIMA believes that the proposed restriction on the use of dealing commission to fund investment research is not justified, and would harm the European asset management industry. We instead believe that investment managers should have in place a robust governance framework, based principally on Commission Sharing Agreements (CSAs), to ensure that the level of research spend meets the test of being a minor benefit, and to ensure that the research is substantive in nature.
- We strongly endorse a heightened focus on investor protection issues, but encourage ESMA to consider carefully the different needs of retail clients and professional clients, ensuring that the client protections and disclosure requirements that are applied in the retail space are not simply copied across to the professional space without considering whether professional clients would derive value from them or whether those provisions would constrain professional clients from negotiating contractual terms that reflect their needs.
- MiFIDII/MiFIR entails numerous reporting requirements - transaction reporting to competent authorities, post-trade reporting to the market, position reporting via trading venues - which have the potential to duplicate one another, or to duplicate the reporting obligations established in other pieces of legislation,

¹ Founded in 1990, the Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry - including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,400 firms (with over 7,000 individual contacts) in more than 50 countries. AIMA's manager members manage a combined \$1.5 trillion in assets (as of March 2014).

² See http://www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir.pdf

³ See http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf

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notably the European Market Infrastructure Regulation (EMIR). We encourage ESMA to design reporting requirements in a way that avoids duplicative reporting as far as possible, whilst facilitating the delegation of those reporting requirements by investment firms to entities with the necessary infrastructure to fulfil them effectively.

- We are concerned that some of the proposals considered in the CP and DP - particularly those relating to Title Transfer Collateral Arrangements (TTCA) - could negatively impact prime brokerage relationships, making it more difficult for hedge fund clients to access a suite of services from their prime broker under the structure of a single agreement. These agreements are vitally important to the hedge fund industry and should be protected.

We look forward to continuing engagement with ESMA and the European Commission regarding MiFIDII/MiFIR. If you have any questions regarding our submission, please contact Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org).

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Jiří Król".

Jiří Król
Deputy CEO
Head of Government and Regulatory Affairs
The Alternative Investment Management Association Limited (AIMA)



Annex 1

The trading obligation for derivatives

- ESMA should develop a structure for categorising contracts that is sufficiently granular that participants have certainty as to which transactions are in scope of the obligation and to ensure that it only applies to appropriate contracts. Packaged trades should be subject to a separate trading obligation determination (i.e. a package transaction should not have to be executed on venue simply because one component of the package is subject to the trading obligation). [DP Q.168; Q.175]
- AIMA strongly supports a framework for applying the trading obligation in which ESMA, rather than trading venues, makes the final assessment of which contracts are sufficiently liquid to trade only on venue, reflecting the fact that trading venues have a commercial incentive to maximise the range of contracts subject to the obligation. [DP Q.171]
- AIMA supports a single start date in respect of the trading obligation for all types of market participants in order to preserve liquidity; the obligation should come into effect 180 days after ESMA has determined that a category of contract should be subject to the obligation. [DP Q.174]
- AIMA believes that a mechanism is required to suspend the trading obligation without the need to redraft legislation; this could be linked to the framework under MiFIR Article 9 according to which the transparency provisions for non-equity instruments can be suspended. [DP Q.171]

Obligation to clear derivatives traded on regulated markets and timing of acceptance for clearing (STP)

- AIMA strongly supports straight-through processing; it is a pre-requisite for electronic trading, limit order books, and multilateral trading systems. By making these things possible, STP improves risk management, promotes market efficiency and facilitates price discovery. [DP Q.607]
- AIMA notes that short-term exposures between entities in the clearing chain are inherent to margin calculations and subsequent collateral movement in the context of central clearing - this is not created or exacerbated by STP. [DP Q.606]
- AIMA cautions against giving clearing members additional flexibility regarding the timeframes for acceptance for clearing; these could become impediments to the operation of STP. [DP Q.612]

Pre-trade transparency requirements for non-equity instruments

- We believe that the proposed application of pre-trade transparency requirements to voice trading venues for derivatives contracts will push such venues towards a hybrid model of execution; to the extent possible, ESMA should apply the waivers established under MiFIR Article to allow voice-based venues to continue to operate. [CP Q.123]

Commodities position limits

- AIMA supports the structure proposed by ESMA, whereby a baseline position limit is set by ESMA, with national competent authorities adjusting that limit. A key point is to ensure the appropriateness of the baseline, but we also believe that a more generous adjustment margin should be allowed (25% rather than 15%). At the same time, trading venues should be closely involved in the establishment of position limits. [DP Q.522]
- AIMA understands that the relevant 'person' to which a limit applies is, in a fund management context, the investment fund. [DP Q.493]



- AIMA believes that aggregation of the positions held by a company in which a person has a substantial ownership stake should only be required where that person is able to exercise control over the portfolio company's trading decisions; this should be based on a qualitative assessment, rather than whether the ownership stake exceeds 50%. Aggregation should be in proportion to the ownership share. [DP Q.493]
- Concert party arrangements should be tackled through the Market Abuse Regulation rather than under MiFID. [DP Q.494]
- AIMA believes that the test of whether OTC contracts are economically equivalent should be based on whether they are true lookalikes for contracts traded on venue. This will ensure that market participants are able to assess on a real-time basis which contracts are relevant from the point of view of position limits. [DP Q.497]
- A three month time period for re-assessment of the market size relative to which limits are expressed is not a sufficiently long time period. Venues should have a direct role in setting the re-assessment period, which should be at least 6 months (although *ad hoc* reassessment may at times be required). [DP Q.502]
- Participants should have 12 months to come into compliance with new limits after a revision to the limits. [DP Q.503-504]
- Limits should initially be calibrated at a cautiously high level so that their effect on liquidity can be monitored; over time, downward adjustment could then be considered. [DP Q.502]

Commodities position reporting

- We believe that reliance should be placed on the EMIR reporting framework wherever possible. [DP Q.535-536]
- We have significant reservations about any reporting solution that would require the transfer of position information and client identifiers up a chain of intermediaries, given that this would compromise client confidentiality. [DP Q.537]
- We encourage ESMA to work with the CFTC to ensure that their respective reporting frameworks are sufficiently aligned that no conflict exists between them and that unnecessary duplication is avoided. [DP Q.544-545]

Transaction reporting

- To assist investment managers and prevent duplicative reporting, we suggest that ESMA allow managers to have agreements with brokers drafted in such a way that, regardless of the legal entity of the broker which was passed the order, the transaction could still be deemed to be transmitted for market data reporting purposes. [DP Q.549]

The legitimacy of inducements

- We do not support ESMA's approach in respect of investment research and believe that this will have a detrimental impact on research coverage - particularly of SMEs - whilst putting the EU out of sync with other jurisdictions. [CP Q.79]
- We believe that ESMA should instead consider the role that Commission Sharing Agreements (CSAs) can play in ensuring that managers exercise control over the level and quality of research spend. [CP Q.79]
- We oppose the suggested read-across of ESMA's approach to UCITS and AIFMD - this is outside the scope of the MiFID framework. [CP Q.79]



Investor protection

- **Product governance:** we believe that the scope of product governance requirements needs to be developed further, with reference to definitions and concepts that already exist in financial services legislation. Funds and their managers should not be covered by this framework, given that they are already subject to sectoral legislation. [CP Q.14]
- **Safeguarding of client assets:** We believe that it is vital to ensure that provisions relating to the use of title transfer collateral arrangements do not restrict or undermine the existing structure of prime brokerage relationships. [CP Q.23]
- **Remuneration:** We encourage ESMA and EBA to work together to ensure that definitions and concepts used in sectoral legislation are sufficiently aligned that firms can develop coherent remuneration policies that can be implemented effectively. [CP Q.63]
- **Information to clients on costs and charges:** We do not believe that the information that is appropriate for retail clients is necessarily appropriate for professionals and eligible counterparties. We also note that it does not make sense to require *ex ante* disclosure of aggregate estimated cost figures that would include costs that will only be known at a later date; *ex post* disclosure is more appropriate. [CP Q.71]
- **Best execution:** We do not believe that it is proportionate to require firms to publish an annual statement of their internal execution monitoring of their top five venues, particularly given that it is not clear that investors would make any use of such information. [DP Q.37]

Microstructural issues - Algorithmic trading and HFT

- **Definition of HFT:** If a definition of HFT is to be created, we believe that cumulative factors should be taken into consideration, such that only those firms which are true HFT participants and utilise latency minimisation as their primary source of competitive advantage are captured. [CP Q.167] Any designation of 'HFT' should not result in a universal characterisation of an investment firms' algorithmic trading activities as HFT. [CP Q.171]
- **Proportionality:** We support the proportionate application of all aspects of the organisational, systems and controls requirements under Article 17 and 48 MiFID II. However, the strict 'minimum' standards contained within the ESMA DP would prevent the effective application of proportionality. [DP Q.197]
- **Testing:** AIMA supports the robust and tailored testing of new or amended algorithms. We believe that the phase-in of algorithms into a live environment, although useful, is not suitable for many portfolio management scenarios. The compulsory use of non-live venue testing environments would be inappropriate as they are not yet able to fully replicate a market and are not universally available. [DP Q.199-203]
- **Change management:** We stress the importance of code management in order to track the changes made to a particular algorithm and person responsible. We believe that testing and sign-off requirements must be dependent upon the degree of change being made, although we do not believe it is possible to provide a universal definition of what may constitute a 'minor' change as opposed to a 'significant' one. [DP Q.204]
- **Security:** AIMA considers that all firms should maintain network firewalls, VPN connections or other security devices and authentication through IDs, passwords and/or token based systems. We also support logging systems to record user and system activity. However, we stress that it is not possible to make any system absolutely secure and are concerned that ESMA's current proposals are too prescriptive. [DP Q.207]



- **Pre-trade controls:** We support the application of appropriately calibrated pre-trade risk controls by investment firms. These include price collars; maximum order values; long/short and strategy positions; and message rate/repeated execution throttles. We accept the value in kill-switches as an absolute last resort, although they are not pre-trade controls. [DP Q.208]
- **Monitoring:** We do not agree with ESMA's proposal for real time and T+1 monitoring. We believe that monitoring should be undertaken at a speed matching the relevant trading system and that flexibility is especially important to ensure that monitoring teams with finite resources are able to prioritise alerts according to their significance. We support the use of drop copies in the monitoring process. [DP Q.205-206]
- **Record keeping and information disclosure:** AIMA believes that ESMA's recordkeeping proposals go beyond what is mandated under the Level 1 text and what is necessary for supervision. In particular, we strongly disagree with the proposal for firms to record all parameters or market data messages as this would be both prohibitively expensive and of limited use to supervisory authorities. [DP Q.210-211, 600]
- **Reviews:** AIMA is concerned that the frequency of reviews proposed by ESMA for testing, monitoring and proportionality self-assessments is unsuitable. We consider such frequency is excessive and could detract from each review's quality. We recommend reviews be undertaken annually or more frequently as necessary. [DP Q.197,201, 205 and 214]

Organisational requirements for Direct Electronic Access

- **Due-diligence:** AIMA strongly disagrees with the proposal for investment firms to provide source code to DEA providers. This could put extremely sensitive intellectual property at risk, as well as provide no utility to the DEA provider. [DP Q.216]
- **Monitoring:** We support the ability of DEA providers to identify individual DEA clients; however, we would not agree with any extension to require individual algorithm identifiers to be passed from DEA user to DEA provider. [DP Q.216]
- **Cancel on disconnect functionality:** AIMA proposes for DEA providers and/or venues to offer clients cancel on disconnect (COD) functionality which enables an investment firm to have its orders cancelled according to the best efforts of the COD functionality upon the connection of the firm to the venue/DEA provider being lost. [DP Q.185]

Organisational requirements for trading venues

- **Monitoring:** AIMA does not believe that trading venues should have discretion to cancel or amend executed orders/transactions unilaterally. Only *de facto* 'error trades' within the meaning of a clear publicly available policy should be able to be amended or cancelled as such. [DP Q.239]
- **Trading halts:** AIMA strongly recommends that, once a halt is triggered, a kill switch be applied so that all existing orders are cancelled and connections need manual reopening by participants in order to prevent disorderly activities continuing once markets restart. [DP Q.240-242]
- **Testing facilities and charges:** AIMA does not believe that separate charging should be made for mandatory testing services such as conformance testing. We believe that venues should be free to charge for any optional testing at the relevant market rate. [DP Q.243-247]
- **Order to trade ratios:** Due to the objectives of the OTR - to penalise excessive systems usage - we strongly recommend that any calibration of OTRs take account only of venue capacity usage rather than



value of orders. AIMA believes that the mandatory OTR should only be applied to cash instruments traded on an electronic venue and which meet the requirement of a liquid instrument for which a liquid market exists within the meaning of Article 2(1)(17) MiFIR. We also believe that only messages that can be actively controlled by an investment firm should be included within the scope of the OTR calculation. [DP Q.290-303]

- **Co-location:** AIMA believes in the transparent, fair and non-discriminatory provision of co-location services. In particular, that all co-location clients should be subject to the same wire length. [DP Q.305]
- **Fee structures:** AIMA supports transparent, fair and non-discriminatory fee structures. In particular, we believe that any discounts should be made public. [DP Q.306-312]
- **Tick sizes:** AIMA believes that trading venues' tick sizes have evolved to be largely appropriate for their markets in order to maximise liquidity at relevant parts of the order book and avoid unduly large spreads. We believe that any EU regime which significantly changes these tick sizes would not be appropriate. We support a system which focuses on the development of tick size 'regimes' whereby venues are able to set tick sizes according to a set of overarching principles and subject to competent authority oversight. [DP Q.330]