

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF response to ESMA consultation on the exemption for market making activities and primary market operations under Regulation (EU) 236/2012

General remarks

- ***Importance of Market Making***

Market making is the facilitation of client trading. It provides liquidity, immediacy of trading and reduces transaction costs. This activity is a vital mechanism in the efficient and effective running of the markets. It contributes to a reduction in transaction costs for market participants, enhanced risk management, and improved access to finance.

Requirements forcing genuine market makers to disclose their positions to the market, restricting their ability to go short, and restricting the instruments market makers can use to hedge (in respect of their market making activity) gives rise to the risk of unjustified commercial prejudice, and restricts their ability to manage their risk and provide liquidity to the secondary markets.

This has been recognised at all previous stages of the legislative process, and is precisely the reason why market making activity was granted an exemption from certain parts of the requirements. It is of fundamental importance that ESMA too pays due credence to the role of market making in helping create efficient and effective markets, when finalising guidance on the market making activity exemption.

- ***Compatibility with Level 1***

The EBF is concerned that ESMA's guidance on the 'exemption for market making activities and primary market operations' is attempting to restrict the market making exemption agreed by policy-makers as part of the Level 1. The EBF stresses that these draft ESMA guidelines are inconsistent with what was agreed and understood as part of the Level 1 legislative process.

Indeed, there is a significant danger that ESMA's draft guidelines will have a damaging effect on liquidity and efficiency in the equity, sovereign debt and CDS markets – and

also in markets where market makers are reliant on these instruments to hedge their positions. The more restrictive the market maker exemption becomes, the more liquidity is threatened, ultimately increasing the cost of trading for end investors. It is essential that ESMA recognise that market makers are not seeking to hide speculative or proprietary trading behind the exemption.

- ***Timing of ESMA Guidelines***

The EBF outlines that ESMA's guidance - as currently drafted - would have a significant and far reaching impact on what is expected of firms, and what they must do in order to implement the new rules in a timely fashion. In EBF's view it is unfortunate that this consultation has been published a matter weeks before firms have to: a) submit their market making notifications; and b) implement the Regulation. Furthermore, ESMA guidelines are not expected to be finalized before the Regulation becomes applicable. This makes it very difficult for firms tasked with implementing/complying with the new rules and particularly with any further guidance around the market making exemption that has also not been finalised. New rules, or guidance around new rules, must be accompanied by a sufficient lead time, particularly when the changes have the potential to have such fundamental impacts on market structure and firms ability to respond to client requests. Firms are also tasked with infrastructure / systems changes that need to be designed and installed in order to effectively implement the Regulation.

Specific remarks

Q1: Do you agree with the above approach regarding the definition and scope of the exemption for market making activities? Please, explain.
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No. The EBF has serious reservations about (i) the instrument-by-instrument approach (ii) the 30 days notification deadline related to the possibility for market makers to hedge position (iii) ESMA's interpretation of 'trading venue' in respect of market making activity; (iv) restrictions on firms' hedging activities and (v) the legal basis of the guidance. These concerns are clearly linked and it will have negative implications for European banks' market making activities and their client base.

i) Instrument-by-instrument approach:

According to Article 2 paragraph 1k of the Regulation (EU No 236/2012¹), transactions performed by entities (investment firm, credit institutions etc.) that are subject to a legal and supervisory framework are considered as market making activities when the entity is 1) posting firm, simultaneous two-way quotes of comparable size and at comparable prices, 2) by fulfilling orders initiated by clients or in response to clients' requests to trade or 3) by hedging positions arising from the fulfilment of tasks under points 1 and 2. Activity falling inside this definition is explicitly exempted from certain other rules (specifically Articles 5, 6, 7, 12, 13 & 14).

On this basis, the EBF considers that the exemption should be based on activities, rather than focusing on specific instruments. Implementing the exemption on an 'instrument-by-instrument' basis would be inconsistent with the Level 1 legislation. Furthermore, such an approach would create significant difficulties for firms performing market making activities, without seemingly offering any benefit to Competent Authorities.

- Specific details of an instrument (i.e. ISIN) provide no meaningful information to Competent Authorities with regard to determining whether a firm's activity in that instrument is genuinely market making activity. The focus should instead be on the trading activity itself, and how or why this fits within the definition laid out in Article 17 of the Regulation.
- European banks conduct market making activity in a wide range of financial instruments. If firms are required to notify on an instrument by instrument basis, they will be forced to seek exemptions for the whole universe of instruments they currently conduct market making activity in (or may conduct market making activity at some point in the future should a client request it). This is inefficient, and will provide discernable benefit to Competent Authorities.
- Furthermore, not all instruments are liquid. Those which are illiquid will trade on a far less frequent/systematic basis. Despite this, our members clients may still wish to trade in these instruments. The fact that a market maker may have not traded a particular share/bond for a period of time should not preclude the market maker from relying on the market making exemption if approached by a client requesting to trade that security at some point in the future.

The EBF therefore suggests that the most sensible approach would be for firms to notify Competent Authorities of their market making activity on an issuer/reference entity level.

¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF>

ii) Thirty days notification deadline:

The instrument-by-instrument approach proposed in the consultation paper leads to a range of practical challenges for market participants and also for the competent authorities who will need to supervise banks' activities on short selling and CDS.

According to section 21 from the consultation paper the notification submitted to the Competent Authority should relate to a particular share or sovereign debt that a market maker would perform market making activities in.

This could create problems in relation to the 30 days notification deadline since it is not always determined in advance which instrument a market participant will choose to fulfill an order as a result of a client's request to trade. For instance, a client could request a share that the market participant has not traded before. If the client and the market participant agree on a price etc. this transaction would be considered as a market making activity according to Article 2 paragraph 1k of the Regulation. However, the dealer would not be able to apply the exemption if the notification to the Competent Authority requires a specification of which particular financial instruments one performs market making activities in 30 days in advance.

Certain financial instruments (e.g. sovereign bonds) are created and distributed expeditiously. If the exemption is interpreted on an instrument by instrument basis, compliance would result in a material time lapse of 30 days following creation of the new instrument, during which - for no ascertainable regulatory purpose - the market making activities exemption would be temporarily unavailable. This suggests that market making activity cannot occur in a particular instrument solely on the basis that it is a new instrument. On the contrary, market making activity is at its most fervent when new instruments (particularly sovereign bonds) have been created /issued. Furthermore, how are firms expected to evidence market making in new instruments (given paragraph 69.b.ix. of the ESMA guidance requires firms with no previous market making activity in a particular financial instrument to provide an expectation of expected daily/weekly volumes)? In this context it should be noted that the 30 day notification requirement (Article 17(6)) is consistent with an activities-based exemption. It is however not consistent with an instrument by instrument approach.

This specification of individual instruments to which the exemption is applied 30 days in advance would also limit the possibility for market makers to hedge positions even though hedging is clearly considered a market making activity.

A possible outcome of this approach would be that those who want to use the exemption would notify the Competent Authority and include all instruments admitted (all MiFID instruments) to trading on a trading venue in the EU in order to ensure the possibility to hedge positions. This situation would only create an extra burden for the Competent Authority who will need to check each individual instrument and transaction.

iii) ESMA's interpretation of the reference to "trading venue"

It appears that ESMA's draft guidelines are based on the premise that, as a condition before a market maker is able to rely on the market making exemption, the instrument (or 'related' instrument) in which the activity is occurring must be admitted to trading on a MiFID regulated venue, of which the market maker is a member, and deals as principal in that instrument.

The EBF consider this to be a fundamental misreading of the Article 2.k of the Regulation. This misreading not only unnecessarily limits the use and scope of the exemption; it cannot be reconciled with the language of the Regulation in its other language versions. Rather, we believe a correct interpretation of Article 2.k is that there is no requirement for a link between the trading venue of which the market maker is a member of, and the financial instruments in which legal person undertakes market making activity. ESMA, in drafting its guidance, has seemingly interpreted the word 'where' (in Article 2.k of the Regulation) in a geographical sense. However, there is sufficient supporting evidence to suggest this interpretation is incorrect, and instead the word 'where' should be interpreted as "circumstances in which" or "when". Taking this interpretation, the pre-conditions would require that a firm undertaking market making activities should be a member of a MiFID regulated trading venue *per se*, and that they deal as principal in the financial instrument for which they are intending to make use of the market making exemption. It is **not** necessary that the specific instrument in which the activity is occurring is admitted to trading on a MiFID regulated venue, or that the market maker is a member of that venue in which it deals as principal in that instrument.

Further to the above, it would seem illogical to require that an instrument (or a 'related' instrument) must be admitted to trading on a MiFID regulated venue. There are lots of instruments subject to the Regulation that do not trade on any venue.

iv) Restrictions on firms' hedging activities

Market making / client facilitation activity should be viewed holistically. It is essential that the market making exemption is interpreted in such a way as to include necessary and reasonable hedging activities that arise from market making and/or client facilitation activities. In this context, the following activities should necessarily be included:

- Proxy hedging as an important means of mitigating risks while market making on, for instance, less liquid corporate bonds markets.
- Market making and hedging in derivatives, underlyings and indices.
- Anticipation of client orders, CVA hedging and portfolio hedging.
- Hedging with indices where the market makers could end up with a short position in shares or sovereigns as a result of the index constituents.

Market makers provide liquidity to market participants. Clearly, this involves taking some amount of direct risk for short periods so client business can be facilitated. This requires them to manage the inventories of positions they take as principal in order to mitigate the risks they are exposed to. Done effectively, this practice allows them to accommodate clients' trades quickly and at favourable prices. If market makers were restricted and left unable to manage this risk effectively, the appetite of market makers to assume direct risk in the process of market making and providing clients with liquidity in the secondary markets would be diminished. Liquidity in the secondary markets would suffer as a result.

Market makers are expected to facilitate client requests quickly, and in a manner that is cost-effective for the client. Clients request their liquidity providers to both buy and sell instruments. In order to facilitate a client sale in a timely and cost-efficient manner, the market maker is required to acquire that instrument as principal (i.e. they assume risk). To manage its risk effectively, and hedge against price movements, the market maker may sell the instrument (or a related instrument). It is not necessary the case that the market maker hedges this risk after the client trade. They may decide to hedge this risk in anticipation of the client request (anticipatory hedging). Indeed, gradually accumulating a short position in anticipation of a large sale by a client (rather than selling after the fact) is often the best strategy for maintaining an orderly market and providing the best prices to clients.

The definition of market-making activities in the Regulation includes trading by a firm as part of its usual business to fulfil orders initiated by clients or in response to clients' requests to trade and also trading to hedge positions arising from the fulfilment of such tasks. In other words the taking of a short position in a financial instrument in order to mitigate risks arising from client facilitation is within the scope of the definition. The definition does not require that such hedging activity take place after the trade with the client. Further, we believe that such activity is within the hedging limb of the definition even where the firm is not posting two-way quotes to the market in accordance with the first limb of the definition.

Finally, the EBF also suggests including in the scope of the exemption the activity that banks put in place to guarantee a certain degree of liquidity to their own issued securities.

v) Legal Basis

In EBF's view, the following points lack legal clarity:

- Bullet point 15: There is no legal basis in the Regulation to demand that persons that have notified the intent to make use of the market maker exemption are "not expected to hold significant short positions, in relation to market making activities, other than for brief periods". This provision restricts the possibility to hedge in correlated instruments which often is a necessity in the illiquid market.

- Bullet point 16: The fact that arbitrage activities are not considered market making activities shall only apply to proprietary trading not trades that are initiated by clients or in response to clients' requests to trade which constitute market making. This follows from the division between market making and proprietary trading under the Regulation.
- Bullet point 17: Hedging activities often take the form of more trades that hedge one position so an exact match is not achievable in those cases. The EBF does not see legal basis for such demand which on the other hand is not reasonable.

Q3: Do you agree with general principles applicable to persons intending to make use of the exemption under Article 17(1) of the Regulation? Please, explain.

It not clear what is exactly meant by the reference to separate arrangements for middle and back-office with respect to the market making activities for which it claims the exemption (bullet point 3). The guidance seems to assume that all firms are undertaking proprietary trading. This is not necessarily the case, and should not be assumed.

Q5: Do you agree with the principles applicable to persons carrying out market making activities in accordance with Article 2(1)(k)(ii) of the Regulation?

The emphasis on whether a person already deals “on a frequent and systematic basis” is a concept related to Systematic Internalisers. The concept of systematic internalisation was one introduced as part of the Markets in Financial Instruments Directive (MiFID). The SI definition does indeed require that activity is performed on an organised, frequent and systematic basis.

However, this definition should be viewed in the wider context of the SI regime. While awaiting the final outcome of the MiFID review and for the time being, a Systematic Internaliser is an equities-exclusive concept, the main goal of which was to achieve a ‘fair deal’ for the small scale retail investor who wanted to trade cash equities. The regime was also limited to ‘liquid stocks’ and trades ‘below standard market size’. Clearly, criteria such as these should not be applied for market making activities *per se*. Further, these criteria should not be applied for market making activities in non-equities, which by their nature, are less homogenous, trade in larger size, and are generally less liquid than equities.

Q11: Would you agree that frequency and systemic basis of the activities exempted under Article 2(1)(k)(ii) capacity should be assessed against the same qualifying criteria as applicable to systemic internalisers under Article 21(1) of the Commission Regulation (EU) No 1287/2006?

The EBF disagrees with ESMA's proposal that the frequency and systemic basis of activities exempted under Article 2(1)(k)(ii) capacity should be assessed against the same criteria applicable to systematic internaliser under Article 21(1) of the Commission's Regulation (EU) No. 1287/2006. See also our response to Question 5.

Furthermore, it is wholly inappropriate for these same criteria be applied for market making activities *per se*. Particularly, these criteria should not be applied for market making activities in non-equities (notably bonds and sovereign CDS), which by their nature, are less homogenous, trade in larger size, and are generally less liquid than equities. Further, it would be inappropriate for these criteria to be applied for any instruments other than those defined as 'liquid' under MiFID, and any trades above 'standard market size'.

Q14: Do you agree with 6 months after application of the Guidelines period for revising and assessing notifications made before entry into force of the Guidelines?

No. In EBF's opinion there is no power in the Regulation for the supervisory authorities to review notifications made before the entry of force of the Guidelines and it is not in compliance with the requirements set in the Guidelines (bullet point 79 in the consultation paper). Such power is not foreseen by Article 17 of the Regulation which clearly states that a competent authority may prohibit the use of the exemption only if the person does not satisfy the conditions of the exemption. The conditions should be interpreted as the conditions of the Regulation and the criteria's for the exemption in Article 2. No further rules are foreseen or delegated in the Regulation.