JOINT PETITION

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Börse München
Börse Hamburg
Börse Hannover
Börse Stuttgart
Tradegate Exchange
Bundesverband der Wertpapierfirmen

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European Securities and Markets Authority (ESMA)
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27 February 2015

MiFID II "Draft regulatory technical standards on market making, market making agreements and marking making schemes"

Consultation Paper ESMA/2014/1570, Chapter 4.3 & Annex B, RTS 15 of December 19, 2014

Dear Sir or Madam,

The petitioners who are securities exchanges throughout Germany[1] together with bwf, a trade association promoting the common professional interests of market makers and independent trading houses in Germany, welcome the opportunity to comment on ESMA's Consultation Paper on MiFID II / MiFIR of 19 December 2014. As already stated in our last petition from July 31, 2014[2] (on ESMA's Discussion Paper on MiFID II/MiFIR[3]), we still have serious concerns regarding ESMA's current proposal for "draft regulatory technical standards on market making, market making arrangements and market making schemes."[4] If adopted in their present form, these standards have the potential to create severe and unjustifiable negative consequences for established and legally recognized "hybrid" market models with liquidity providing functions.

The main reason for our concern is ESMA's interpretation of the expression "fair and non-discriminatory" in RTS 15, Article 9 (as applied to access to market making schemes) and its insufficient consideration of situations where it would be unreasonable to require an exchange to introduce a market making system.

Regulatory objective

ESMA notes in Recital 1 of RTS 15 that one of the main goals of MiFID II concerning the contractual obligations of firms with market making strategies based on algorithmic trading is to introduce "an

1 All of the participating exchanges run at least one "hybrid" market model based on auction systems with market maker support in accordance with Article 17(5) MiFID I Implementing Regulation. For the majority of the petitioners, market maker supported trading is the sole or prevailing form of trading. Depending on the market model, market making firms may be referred to by different names, e.g. "Designated Sponsors", "Skontroführer", "Spezialisten" or "Quality-Liquidity-Providers".

2 http://www.esma.europa.eu/system/files/esma_mifid2_dp_bwf_joint-petition-german-exchanges-with-bwf.pdf.

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

4 Consultation Paper ESMA/2014/1570 Annex B, RTS 15.

element of predictability to the apparent liquidity in the order book"[5] and to enable market participants "to transfer risks efficiently during stressed market conditions" thanks to the activity of market makers.[6]

In the Level I text, Recital 59 clarifies that the obligations for algorithmic traders pursuing a market making strategy are to be understood in the context of a more general attempt to regulate "risks arising from algorithmic trading." Further, Recital 60 emphasizes that the pursuit of a market making strategy "should be understood in a way specific to its context and purpose" and should *not* be confused with a general definition of market making activities.[7]

These Level I provisions and the practical consequences arising from them, as identified by ESMA, require that all elements of the proposed technical regulatory standard 15 contribute to:

- Reducing the risks arising from algorithmic trading, and
- Promoting and ensuring the continuous and predictable provision of liquidity to the market.

Between any two alternatives proposed, the regulatory framework that better serves these goals is clearly preferable. Equally important, an intervention in the current market structures is only justified if it contributes to at least one of these goals.

Fair and non-discriminatory market making schemes (RTS 15, Article 9)

According to Article 48 Paragraph 12 (f) MiFID II, ESMA's mandate is to identify "requirements to ensure that market making schemes are fair and non-discriminatory." In the draft RTS 15, ESMA calls for a transparent procedure with publicly disclosed conditions. This procedure must ensure that "all members engaged in a market making agreement who perform equally in terms of presence, price and size" receive "the same incentives, terms and conditions" and do so "according to published, non discriminatory and objective criteria." We concur wholeheartedly with this objective. However, we disagree with the wording of RTS 15, Article 9, Paragraph 4, which states "exchanges shall not limit the number of participants in a market making scheme." Our rationale is as follows:

First, an "unlimited-access-clause" is not a criterion for determining that the admission procedure is "fair and non-discriminatory." Were this the case, any arrangement where the number of participants is limited – either naturally or by choice – would be per se "unfair."

Second, the requirement that the number of participants in a market making scheme must not be limited, irrespective of the characteristics of the security in question, is contrary to the broader goals established in Level I and further specified by ESMA itself.

In particular, in the case of less liquid and illiquid securities market makers become even more important. As can be seen from today's markets, less liquid securities are unattractive for algorithmic traders "pursuing market making strategies" in accordance with Article 17 (3) MiFID II. Consequently, an incentive scheme for securities that do not fall into the "blue chip" category has to provide for a degree of "liquidity concentration" if it is to be attractive to traders and if it is to be sustainable.[8]

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[5] ESMA previously described the purpose of articles 17 and 48 of MiFID II with respect to market making strategies as being "to reduce the impact of potentially systematic volatility peaks in instruments where algorithmic traders are present." Discussion Paper ESMA/2014/548, Chapter 4.4, Paragraph 52.

[6] While we fully agree with the first goal, we are less certain that the second can be directly derived from the Level I text. ESMA's wording might create the impression that "new risks" from "advanced technologies" mainly arise from market participants *other* than algorithmic traders pursuing a market making strategy, whereas our understanding of the MiFID II text is that it is the risk arising from the hitherto unregulated de facto market makers that needs to be addressed first.

[7] For instance, Recital 60 refers to the definition of "market making activities" in Regulation (EU) No. 236/2012 on short selling and certain aspects of credit default swaps. In the interests of eliminating ambiguity, we therefore recommend that ESMA avoid the use of the expressions "market making" and "market maker" in RTS 15 and refer, instead, to "market making strategy" and "firm pursuing a market making based on algorithmic trading."

[8] ESMA's remark in the Consultation Paper that respondents to the Discussion Paper were against the possible limitation of the number of participants in market making schemes (see CP, Chapter 4.3, Paragraph 40) must be seen in context, since the initial proposal in the Discussion Paper was that market-making schemes would apply only to liquid instruments.

In this context, we would like to note that the need for a more nuanced approach that takes into consideration a security's "base liquidity" has also received support from academic scholars. In response to ESMA's earlier Discussion Paper, the chair of e-Finance at the Goethe University, Frankfurt called for a "monopolistic" approach that ensures that sufficient liquidity is available even for less liquid securities.[9] We, the signatories of this petition, strongly support this view. Further, we note that, for a large number of more or less illiquid instruments, the goal of ensuring sufficient liquidity might best be achieved with market models outside the "minimum standards" established for "market making schemes" in Article 48, MiFID II.[10]

In addition to having a potentially deleterious effect on the provision of liquidity, unlimited access to "market making schemes" irrespective of whether the security in question is liquid or illiquid is also likely to have other unintended consequences. Even assuming that exchanges succeed in attracting a sufficient number of participants to market making schemes for less liquid securities by offering suitable incentives, they will not be able to ensure price quality: competition among the firms (all of whom will be functioning under identical quoting obligations) for matching the limited number of orders in this category will lead to speed of execution rather than price being the decisive factor in trade. Consequently, the technological "arms race" that has so far been a characteristic only of high frequency trading may also become a concern in this field. This would be contrary to the intent of the regulation, which originally aimed at a reduction in the risks arising from algorithmic trading.

Situations in which it is unreasonable for an exchange to have a market-making scheme in place (RTS 15, Articles 6 and 7)

In addition to calling for the creation of criteria for the fair and non-discriminatory operation of market making schemes, Article 48 Paragraph 12 (f) MiFID II also calls for the clarification of the conditions under which the introduction of a market making scheme might be inappropriate, especially in view of the "nature and scale" of the trading activity. This provision aims to concretize Article 48 (2) (b) MiFID II, which notes that the obligation to introduce market-making schemes applies only if such an introduction is appropriate to the nature and scale of the activity.

However, ESMA has not as yet provided sufficient guidance on the circumstances under which firms would be exempted from this requirement with regard to either the specific market model ("nature of trade") or to the conditions of liquidity ("scale of trade"). The proposal for RTS 15, Article 7 merely notes that exchanges that do not permit algorithmic trade on their systems should be exempted from having to introduce market making schemes. It is true that ESMA's mandate also includes to take into consideration whether an exchange permits algorithmic trade. However, one can already derive an "exception" for exchanges that do not permit algorithmic trade from the conditions for introducing a market making strategy listed in Article 17 (3) MiFID II. As for determining whether an exchange permits or enables algorithmic trade, ESMA has substantially widened the definition of the concept in Article 1 (1) RTS 15 (indeed, it has practically redefined it) when it notes that the characteristic features of algorithmic trade are electronic transmission and matching of orders. By this definition, almost all of the trade currently conducted on European exchanges must be classified as "algorithmic." This clearly cannot have been the legislator's intent. ESMA lacks the authority to exceed the legislator's intent in framing technical standards. The latter has explicitly specified in Article 4 Paragraph 1 (39) MiFID II what is to be understood under "algorithmic trade." We therefore request that ESMA either strike out Article 1 (1) RTS 15 or revise it to conform to the legally binding provisions of Article 4 Paragraph 1 (39) MiFID II.

By making the question of whether or not an exchange is required to introduce a market making system solely dependent on whether or not it permits and/or enables algorithmic trade on its systems, ESMA

[9] Answer to ESMA question 281: "As only liquid instruments should be in the scope of the market making arrangements/schemes, a non-discriminatory access to market making arrangements and consistent incentives/informational/technological advantages should be provided across all market makers. This obviously should be different in case of less-liquids (that are not in the scope here) as for less-liquids mostly only monopolistic positions of the liquidity providers provide a real incentive to assure liquidity provision." Source:
http://www.esma.europa.eu/system/files/esma_mifid2_dp_chair_of_efinance_goethe_university_frankfurt_replyform.docx.
[10] Please refer to the discussion of RTS 15, Article 7 below.

has clearly failed to fulfill its mandate as specified in Article 48 Paragraph 12 (f) MiFID II. While the legislator clearly intended the latter to be one criterion, it was to be so in the context of further conditions to be defined by ESMA. These conditions were to be modulated to the nature and scale of trade at the exchange; they were to be decisive for determining whether the introduction of a market making system was warranted.

In passing the legislation containing Article 48 Paragraph 12 (f) MiFID II, the legislator was clearly aware that some exchanges operated in regulatory environments with higher standards (either due to national legislation or legal norms or private contracts) for liquidity and price quality and higher levels of protection against the risks of algorithmic trade and algorithmic high frequency trade than were envisaged in the MiFID II legislation. These exchanges frequently integrate liquidity providers into their market models and the latter are legally required (either by law or by contract) to ensure a consistently high quality of trade and protection. These market models are thus distinguished from the market making systems as defined by ESMA in the current draft RTS 15 not only in terms of offering higher levels of quality and protection but also in terms of their legal form.

If, as ESMA recommends, the question of whether an exchange must introduce a market making system is made solely dependent on whether it permits and/or enables algorithmic trade on its systems (Article 6 RTS 15), even exchanges that already offer levels of protection against algorithmic trade and high frequency trade in excess of the requirements of MiFID II and already ensure the continuous and predictable provision of liquidity will be forced to introduce market making systems. The sole purpose of these systems, however, was to close a regulatory gap by introducing minimum standards for the provision of liquidity by de facto market makers on the basis of algorithmic trade, whereas this was never an issue at established and proven trading systems with market making functions.

It would therefore be unreasonable to require the introduction of a market making system at exchanges that, either through their market model or through the contractual and/or legal obligations they impose on liquidity providers, have already ensured that trading takes place in a fair and regulated manner as well as made sure that the risks of algorithmic trade and algorithmic high frequency trade are contained and that liquidity is provided on a continuous and predictable basis. It would similarly be unreasonable to require the introduction of a market making scheme if this were to lead to a worsening of the quality of trade or to an increased vulnerability to the risks of algorithmic trade and algorithmic high frequency trade. Furthermore, as was already mentioned in our discussion of RTS 15, Article 9, the chances that the introduction of market making systems will lead to an increased readiness to provide liquidity for less liquid or illiquid securities are slight. On the contrary, the established market models, which have specialized in the provision of liquidity for less liquid securities and are based on the principle that different securities firms should be exclusively responsible for different securities, have proven their worth even under the most challenging of market conditions. Compulsory introduction of market making schemes – especially if, as proposed in Article 9, Paragraph 4, RTS 15, they entail unlimited access to these systems – will almost certainly worsen the liquidity situation for the majority of securities traded on these schemes. The proposal thus stands in a manifest contradiction to the primary goal of ensuring liquidity.

We therefore urge that Article 7 RTS 15 be reformulated as follows:

"As an exemption to the provisions of Article 6, exchanges shall not be required to introduce market making systems:

a) For systems or specific segments of systems for which they neither permit nor enable algorithmic trading, or if

b) The introduction of a market making system would, in the exchange's assessment, lead to a worsening in the quality of trade and/or liquidity for a particular security, or if

c) The introduction of a market making system would, in the exchange's assessment, lead to an increased vulnerability to the risks of algorithmic trade and algorithmic high frequency trade at the exchange.

In case of points b) and c), the exchange is responsible for ensuring that its market model imposes obligations on market participants pursuing a market making strategy which do not fall below those specified in Article 4."

Summing up, we once again explicitly request ESMA to consider a revision of RTS 15 in light of the arguments presented here. In particular, we request that it consider the possibility of limiting the number of participants in market maker schemes in the case of less liquid securities and the possibility of exempting certain exchanges – or certain trading segments of theses exchanges – from the requirement to introduce market maker schemes where these appear to be unwarranted given the nature and scale of the trade.

Failing such a revision, we fear that RTS 15 will, especially in the case of less liquid securities, fail to meet the primary regulatory goal of a continuous and predictable provision of liquidity, that the liquidity situation for these securities will worsen dramatically in the future, and that, beyond this, the spread of algorithmic high frequency trade will be further encouraged.

Given that the proposed standards pose a concrete threat to established and proven market models that have succeeded, even during a global financial crisis, in providing sufficient liquidity at all times even for less liquid securities and that these models could be replaced by lower regulatory standards (which, furthermore, have yet to prove themselves under real-life conditions), we are forced to underscore that such a far-reaching regulatory intervention requires the legislator's explicit authorization and may not be a side-effect of the implementation of a "technical" regulatory standard.

The legislator, however, explicitly did not envisage a fundamental change in proven market structures in the field of market making when formulating guidelines for the various algorithmic market making strategies of "shadow market makers," who had hitherto operated in a regulatory grey area. This is clear from the fact that the definition of "algorithmic market making strategies" in Recital 60 of MiFID II is clearly distincted from the definition of market making found in other European legislation.

We therefore request ESMA to bear in mind when redrafting RTS 15 that its mandate does not extend to the development of draft technical standards for market making activities under MiFID II as such, but simply concerns the need to close a regulatory gap by defining the minimum standards for a specific, limited range of algorithmic trading with market making characteristics that has, so far, not been subject to any obligation regarding its provision of liquidity to the markets.

Yours sincerely,

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